

Trading the Risk: Financialisation, Loyalty and Emerging Market Government Policy Autonomy

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Abstract:

This thesis considers the link between financialisation and emerging market government policy autonomy. It analyses the government bond markets of three case study countries: Brazil, Lebanon and Turkey. Using extensive interview data in the three countries, and interviews with financial market actors in London and New York, the study explores the investment behaviour of a range of investors: commercial banks; individual investors; mutual funds; pension funds and hedge funds. The thesis uses the framework of financialisation – measured by the ability to trade risk – to analyse both international and domestic investors. The study shows that increased financialisation, of both financial market actors and the structure of government bond markets, generally serves to reduce loyalty and therefore reduces government policy autonomy. However, it is demonstrated that initial financialisation – the development of pension and mutual funds – serves to increase autonomy. This is captured by the construction of an ‘autonomy curve’. The conclusions suggest an updating the use of Hirschman’s concept of voice, exit and loyalty in the analysis of financial markets, to give a greater emphasis on loyalty and to include the use of ‘disloyalty’, the ability to short securities. It is also argued that financialisation is the appropriate framework to analyse processes of change in financial markets. The thesis also makes observations as to the true extent of government policy autonomy in emerging market countries, and policy recommendations regarding those governments’ attitude to financialisation.

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Chapter 1

Introduction

Introduction

‘Why does anyone want to buy [the bonds of] a government which is allocating...all its revenues on interest payments?...It’s a Ponzi scheme.’¹ The interviewee who expressed this view is the London-based manager of a fund that invests in the bonds of approximately 65 different emerging market countries. He was talking about Lebanon, which in recent history has endured a full range of man-made misfortunes: civil war, foreign invasion and continued interference, political assassination and politics at the mercy of regional instabilities (Fisk 1990; Friedman 1998; Blanford 2006; Traboulsi 2007). During the 15 year civil war that ended in 1989, a third of the population left the country (Traboulsi 2007: 238) and the United Nations estimated damage to infrastructure at US\$25 billion (Bank Audi undated: 32). Pity the nation, indeed, but do not buy its bonds. The attitude of the investor quoted above was widely, if less strongly, held across 39 international financial market actors interviewed in London and New York during 2005 and 2006. Only two had ever owned Lebanese bonds, and they only briefly; few even followed the country closely. For many, a cursory look at the potential return from investing in the bonds showed the yields available to be far too low when compared to similarly creditworthy countries. Lebanon is rated B3 by Moody’s, with a negative outlook: ‘ratings lower than this are usually reserved for countries that are already in default’.² Yet Lebanon has foreign debt, composed mainly of international

¹ Fund manager, London, interviewed 18 October 2005. For a definition of a Ponzi scheme, see Fry 1997: 13.

² Tristan Cooper, Moody’s analyst, quoted by *Daily Star*, 5 July 2007.

bonds, equivalent to 85.7 per cent of Gross Domestic Product ('GDP'), and domestic debt equal to a further 88.9 per cent of GDP.³ Who is buying Lebanon's debt and why?

While the 'who' part of the question is relatively easily answered, and goes some way to explaining the Lebanese situation, this initial question raises further questions regarding both international and domestic debt. Lebanon is one of the middle-income countries commonly called 'emerging markets' (for discussion of the term, see Mosley 2003: 103). Emerging markets can describe debt or equity markets, but the focus in this study is the government debt markets of these countries. Considering first international debt, 31 countries make up the 'EMBI Global', one of the emerging market bond indices compiled by the U.S. bank JP Morgan which measure the performance of emerging market bonds across a range of countries (see Appendix A; JP Morgan 2004). The 'EMBI Global' is an index for US dollar denominated debt. Lebanon's foreign debt, mostly in US dollars, is easily the highest of these countries at 104.4 per cent of Gross National Income⁴ ('GNI'): no other country has foreign debt to GNI above 90 per cent and most are far lower. Even more noticeable is the wide variation in the external debt levels, with the lowest, China, at only 12.5 per cent, and an average of 46.1 per cent.

A similar variation in the ability to borrow can be seen for domestic debt. 23 countries make up the main bond index for domestic bond markets, the 'EMLI+'.⁵ Lebanon's domestic debt is 88.9 per cent of GDP,⁶ higher than all the countries that make up the EMLI+, with the exception of the anomalous Singapore.⁷ The lowest ratio is Hong Kong's 1.0 per cent (IMF 2006h: 23). How can these variations in both domestic and international debt levels be explained, and what are their implications? To explore these

³ Gross government debt (IMF 2006e: 9).

⁴ To allow a standardised comparison, Appendix A uses World Bank 2005 figures for foreign debt relative to GNI, rather than to GDP.

⁵ 15 countries appear in both domestic and international indices, 8 only in the domestic (The Czech Republic, Hong Kong, India, Indonesia, Israel, Singapore, the Slovak Republic and Taiwan). 16 countries, including Lebanon, are only included in the EMBI Global index.

⁶ Gross government debt (IMF 2006e: 9).

⁷ Singapore issues domestic government bonds to develop the country as a regional financial centre, rather than for government borrowing, and invests the proceeds in foreign assets (IMF 2006g: 26).

questions, this study focuses on two emerging market countries in addition to Lebanon: Brazil (8.8 per cent government external debt and 58.5 per cent government domestic debt to GDP⁸) and Turkey (17.8 and 50.2 per cent⁹). Not only will the reasons behind the variation in overall debt levels, both international and domestic, be explored, but also the implications of this variation for the autonomy of the government of each country from the policy preferences of international financial actors.

Brazil is in many ways very different from Lebanon. It ranks amongst the world's ten largest economies, 47 times larger than Lebanon,¹⁰ has a sophisticated financial system,¹¹ and was, in February 2004, the largest country component of the EMBI Global index with a weighting of 19.01 per cent (see Appendix A). It is rated a far higher BB+ by Standard and Poor's. Turkey's economy is just under 40 per cent the size of Brazil's. Turkey is the fourth largest EMBI constituent at 6.22 per cent (Lebanon, despite its high indebtedness, is only 1.12 per cent), and its financial system's sophistication, as discussed extensively below, lies between the levels of Brazil and Lebanon. Its rating, BB- from Standard and Poor's, similarly lies between the other two case studies. Aside from their position as potential emerging market bond investment destinations, these are very different countries.

The three countries are different not only in the levels of debt currently, but in what is considered sustainable. Debt sustainability is a difficult concept to analyse with any precision (Daseking 2002; International Monetary Fund 2006e: 28), but the three countries' experiences are remarkably at odds with each other. In the run up to the 2002 presidential elections, Brazil's net public sector debt to GDP moved above 60 per cent in

⁸ Gross government debt as of end 2005. Source: Banco Central do Brasil.

⁹ Gross government debt as of end 2005. Source for government debt: Turkish Treasury. Source for GDP: www.tuik.gov.tr, accessed 13 November 2007.

¹⁰ As of end 2006. Source: World Bank, <http://siteresources.worldbank.org/DATASTATISTICS/Resources/GDP.pdf>, accessed 27 August 2007.

¹¹ Demirgüç-Kunt and Levine (2001: 121) classify both Brazil and Turkey as 'financially underdeveloped market-based economies', by a measure of bank credit to the private sector and equity market turnover. My focus, the government bond market, agrees with the categorisation of Brazil as 'market-based', but sees its government bond market as developed (see Gleizer 1995: 223; Carvalho and Garcia 2006).

what was termed a ‘death spiral’ (Krugman, 2002: 2), and the *Financial Times* concluded in an editorial (15 October 2002): ‘At current market rates, even an optimist would admit Brazil is insolvent’. On 9 August 2002, the economist Barry Eichengreen forecast default (Santiso 2004: 23). In 2001, a financial crisis pushed the net debt of the Turkish public sector to 90.5 per cent of GNP (IMF 2006a: 35), necessitating an International Monetary Fund (‘IMF’) programme which successfully targeted a 6.5 per cent of GDP primary surplus. Lebanon, meanwhile, has seen gross debt to GDP in 2005 of 174.6 per cent, leading the IMF to conclude: ‘For years now, Lebanon has been able to sustain a government debt-to-GDP ratio which is well beyond levels deemed sustainable’ (IMF 2006d: 28). There are clearly differences in need of explanation, not just between Lebanon and the other two case studies, but also between Brazil and Turkey.

Chapter Structure

The central research question of the thesis will be discussed next. This question will provide a framework for the analysis of the differences in borrowing levels and their implications. Two of the key terms in the research question will be defined. The approach to answering this question will then be discussed. The appropriate level of disaggregation of financial markets will be considered, and, crucially, the considerable focus in this study on domestic financial market actors will also be justified. Key issues regarding the particular methodological approach will next be addressed, concentrating on the two areas in which this study is somewhat unusual in its approach to analysing financial markets. First, the use of extensive interviewing and, second, the case study approach will be justified, and the choice of Brazil, Lebanon and Turkey as those case studies. Consideration will then be given to the issue of investor policy preferences, in particular possible differences between international and domestic investors. The study makes extensive use of Hirschman’s (1970) ideas regarding voice, exit and loyalty, and the following section will discuss these ideas, and how their use in this thesis differs from the more common usage. An alternative explanation for the variable considered in

this thesis, and for the debt levels discussed above, is then considered. This alternative is financial repression. The chapter ends with an outline of the structure of the remainder of the thesis.

The Research Question

In this study, I take as my independent variable a concept that allows a simultaneous consideration of both domestic and international markets and actors: financialisation. My research question is:

What is the link between emerging market government autonomy from the policy preferences of international financial market actors and the financialisation of government bond markets?

Before elaborating both on the question itself and the research methodology that will be employed, it is necessary to define what is meant by both financialisation and government policy autonomy.

Financialisation

Financialisation is defined here simply as the increased ability to trade risk. As will be demonstrated, the ability to trade risk is influenced by multiple constraints. The overall financialisation of a government bond market is the result of the financialisation of the financial actors in the market (i.e., the ability of the actors themselves to trade risk) and the financialisation of the structure of the government bond market itself (i.e., the constraints on the trading of risk in the particular market). Examples of factors that might influence the financialisation of the financial actors include the investment mandates which control how they can invest, the nature of their liabilities and the amount available to invest. The financialisation of the structure of the government bond market itself is influenced by factors that include the market's size, the financial

instruments that exist, and the ease of the settlement of transactions.¹² These two facets of financialisation interact to determine the overall level of financialisation of a government bond market. This overall level is determined by the ability of the investors that dominate the market to trade risk. A hedge fund may itself be able to follow complex, short term trading strategies, but will only be able to do so if the financial instruments exist to facilitate such strategies. Similarly, the instruments may exist, but if the investors able to follow these strategies are not interested in a particular government bond market, the strategies will not be followed.

Financialisation is a relatively rarely used term in IPE, where the focus has been far more on globalisation and internationalisation. An exception is Epstein 2005a. The three reviewers on the back cover of Epstein's edited volume each offer a different description of the financialisation the book discusses. This highlights the fact that, as yet, in IPE or elsewhere, the term lacks an agreed definition, and has been used to mean a variety of different developments within domestic and international economies (see Krippner 2005: 181; Epstein 2005b: 3): the dominance of 'shareholder value' in corporate governance, 'a change in orientation towards financial results' (Froud *et al.* 2000: 104¹³; for an application to Turkey and the government debt market, see Ertürk 2003), a part of the developments leading to 'finance-led growth' (Boyer 2000),¹⁴ 'a pattern of accumulation in which profit-making occurs increasingly through financial channels rather than through trade and commodity production' (Krippner 2005: 181); the increasing prevalence of capital market systems rather than bank-based financial systems; the increasing sophistication of financial markets; or the increasing entry of financial markets into our everyday lives (Martin 2002; Langley 2007¹⁵). Epstein, in a deliberately broad definition that covers all of the above, terms financialisation 'the

¹² Settlement refers to the process by which ownership of securities and cash payments are transferred.

¹³ Froud *et al.* also note 'a kind of speed up in management work' (2000: 104) which can be seen as the result of a more short-term focus from shareholders.

¹⁴ Froud *et al.* (2002) contrast their approach from Boyer's (see also Ertürk 2003).

¹⁵ Strange (1997c) sees the same development, but without terming it financialisation.

increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of the domestic and international economies' (2005b:3).

The definition of financialisation I use in this study is closest to the process described by Aglietta and Breton (2001), although financialisation is not a term they employ. They link the change to a market-based from a bank-based financial system to financial liberalisation and financial innovation linked to the increasing power of technology:

[I]n finding ways of unbundling risks into elements to which theoretical probability distributions could be assigned, computer-assisted financial engineering has drastically enlarged the market logic of pricing. As a result, groups of securities linked to derivatives have blossomed and are traded daily, mainly on over-the-counter markets. The diversity of risk characteristics has been repackaged into a one-dimensional structure of spreads above conventional benchmark prices (2001: 437).

Aglietta and Breton note the presence of both bank-based and market-based finance within a financial system, and also recognise, at least as far as banks are concerned, changes in the activities of an institution, as banks add a 'new market portfolio' to their 'traditional credit portfolio' (2001: 441). Both these observations suggest a nuanced view of change within a financial system, which is also followed here.

In delineating financial systems, nevertheless, Aglietta and Breton continue the approach of the widespread 'varieties of capitalism' literature (Hall and Soskice 2001) or more specifically 'comparing financial systems' (Allen and Gale 2000). Connected to this is clearly the debate regarding the processes and extent of a convergence in national systems as a result of globalisation (e.g., Berger and Dore 1996; Dore 2000), and, for developing countries in particular, the impact of financial structure on economic growth (e.g., McKinnon 1973; Demirgüç-Kunt and Levine 2001; Stallings 2006). This study continues such a comparative approach with the three case studies, but does not attempt a categorisation of financial system or structure. Financial systems are rather seen as lying along a continuum (Stallings 2006 applies the same approach to questions of

liberalisation), as their degrees of financialisation increase.¹⁶ This approach, as well as allowing a more nuanced picture of financial systems, also serves to highlight two important points raised by Aglietta and Breton. First, as will be demonstrated below across all investor types, the activities of investors change even while their ‘type’ remains unchanged. For example, banks, mutual funds and pension funds all change their investment activities as opportunity allows or requirements dictate. Differences in the investment activities of what are notionally the same type of investor represent an important part of the varied level of financialisation in Brazil, Lebanon and Turkey. Any analysis that employs a static conception of the investors in government bond markets (or elsewhere in the economy) will miss this central process of change.

Second, Aglietta and Breton emphasise the necessity of ‘liquidity’, the ability to buy and sell securities. This is similar to Dore’s (2000) view that a dual process of financialisation and marketisation is occurring. Dore’s main purpose in considering marketisation in conjunction with financialisation is to contrast current Anglo-American capitalism with Hilferding’s financialisation of capitalism (2000: 9), but he concedes that ‘[p]erhaps ‘financialization’ alone would do’. The ability to trade risk includes both the ability to analyse and the ability to buy and sell (as Aglietta and Breton emphasise), such that both are part of the process of financialisation. Maxfield (1997: 37) makes the specific connection between liquidity (for her, ease of exit for international investors) and government policy autonomy: ‘pressure on recipient countries to stick to the policy path “promised” at the time an investment is made rises with the liquidity of the investment stock’.¹⁷ As will be outlined in each of the chapters, the ability to trade covers a number of different areas, including regulation and liberalisation, the liquidity of the market, restrictions related to investment mandates and performance measurement.

¹⁶ An alternative approach is used by Morin, who describes the transformation of France from a ‘financial network’ to a ‘financial market’ economy. The term ‘financial network’ covers ‘large groups of actors organized in large systems of inter-corporate alliances’ (2000: 37).

¹⁷ This observation applies to portfolio investment the more general contrast between fixed and mobile assets (e.g., Frieden 1991a: 8).

This is therefore not a study that follows the more common approach for IPE studies of developing countries by focusing on internationalisation as the independent variable. Internationalisation, as far as government bond market debt is concerned, can be seen as the increasing involvement for cross-border investors in a domestic capital market, or in a government's international borrowing programme. So, internationalisation would increase as a result of international investors buying local currency-denominated government debt (e.g., US investors buying Turkish lira-denominated debt issued by the Turkish government), or by a government choosing to borrow through bonds denominated in a foreign currency (the Lebanese Republic issuing US dollar bonds, for example). This is not disputed, although, as discussed below, the extent of internationalisation under this measure has generally been overstated: 'international' debt may not be as international as commonly perceived. However, even in such a narrow issue area as government borrowing, internationalisation covers a far broader range of activities, so that internationalisation is the increase, within a government debt market, of: 1) the involvement of cross-border financial actors, either as owners of government debt or of financial institutions which own that debt; 2) the use of international regulation or regulatory practices; and 3) the adoption of market practices, including institutional investor type, that mirror those in the international market. However, internationalisation, just as liberalisation, is only a part of the process that leads to the financialisation of a government bond market, not the independent variable in this analysis.

The adoption of 'international' market practices as part of internationalisation potentially overlaps with processes of financialisation. For example, should the emergence of domestic hedge funds in Brazil be seen as the result of internationalisation or financialisation? The consideration of issues of financialisation rather than internationalisation leaves this question aside, focusing on the outcome that there are many active hedge funds in Brazil. The important point for this study is that, although some differences will be demonstrated between Brazilian hedge funds and those based

in developed countries, the similarities between institutions of the same broad type, regardless of their geographical domicile, is the more salient observation. The same observation applies to other categories of investor in government bond markets. The geographic origins of these market practices are not the central issue, as the focus here is more on outcomes. This approach varies from, for example, that of Sobel (1994), who attached considerable importance to the privileging of US rules and technologies in securities markets. Sobel sees the process as producing ‘an outcome generally consistent with US actors’ preferences, as others choose options already enacted in the US market, reducing transaction costs for American firms and professionals overseas’ (1994: 151; also Frieden 1987; Strange 1994). As will be demonstrated, a financialised government bond market is an outcome which is consistent with the preferences of those who can gain from an enhanced ability to trade risk, and this group is best understood by considering different investor types, rather than prioritising geographic origin. By using financialisation, domestic and international processes can be considered as part of a single development. As Frieden and Martin (2002: 145) observe, ‘the integration of domestic and international levels of analysis’ is ‘[t]heoretically...the most important frontier’ in IPE.

Government Policy Autonomy

What is meant in this study by government policy autonomy? Government policy autonomy in this study is measured by a government’s ability to borrow, on a sustainable basis, without having to follow the policy preferences of international investors. The Lebanese government’s ability to borrow 175 per cent of GDP, rather than the Brazilian government’s 60 per cent, represents an enormous increase in the former’s relative ability to spend rather than tax. A focus on government autonomy from the policy preferences of international financial actors goes to the heart of a debate within IPE regarding the impact of financial globalisation. This debate has considered the wide range of capital flows (for an overview, see Garrett 1998a). The choice to analyse specific private sector flows, to consider government debt only, requires

justification. This lies at the heart of the link between borrowing capacity and government policy autonomy. 'I used to think if there was reincarnation, I wanted to come back as the President or the Pope or a .400 baseball hitter. But now I want to come back as the bond market. You can intimidate everyone' (James Carville, Clinton campaign strategist [quoted by Greenwald 1994]).

Mosley also chooses to consider government bond markets as her area of analysis for the influence of financial globalisation, because:

[I]t provides a *most likely* location for the operation of financial market pressures. In the sovereign debt market, national governments borrow funds in order to compensate for revenue shortfalls or to fulfil other economic management objectives...those interest rates represent the government's financing costs. When market participants punish governments, they do so by increasing the interest rates at which they will purchase government securities (2003: 17; italics in original).

As she also notes, government interest rates tend to set those throughout the economy (also Maxfield 1997). The figures for indebtedness above highlight that there are a number of further issues which make government bond markets such an appropriate area of study. Not only the cost, but also the amount and the maturity (the date of repayment) of the debt are significant (Mosley 2006). The European Union's experience with trying to limit debt-to-GDP levels for participants in European Monetary Union (to 60 per cent) demonstrates the political importance of government borrowing.

At one level, the amount of government borrowing is a political decision. As former US Treasury Secretary Robert Rubin's (2003:351) defence of 'Rubinomics' makes clear, this decision has been highly contested in the United States. The variation in the ratios of government debt to GDP demonstrates the lack of consensus across the developed world: very high in Greece (107.5 per cent), Italy (106.4 per cent)¹⁸ and Japan (176.0 per

¹⁸ Source for EU countries (2005): Eurostat yearbook 2006-07, page 163. Available at http://epp.eurostat.ec.europa.eu/cache/ITY_OFFPUB/KS-CD-06-001-06/EN/KS-CD-06-001-06-EN.PDF, accessed 3 July 2007.

cent),¹⁹ and across the EU-25 ranging from 4.8 per cent (Estonia) to Greece's 107.5 per cent. The United States stands at 61.9 per cent. The reasons for such variation certainly merit research, but there remains an important difference between developed and emerging market countries. In the developed world, governments can generally increase their debt levels substantially²⁰ - 'as much as they wish' (Griffith-Jones 1991: 117) - if they make that political decision.²¹ Japan's government debt to GDP has increased from 51.9 per cent in 1980 to 176.0 per cent in 2005, for example, and the figure in the United States varied between 42.6 and 73.3 per cent in 1980 – 1993 (see also Frieden 2006: 378). In developing countries, however, the capacity to increase government debt substantially on any sustainable basis is much more questionable. The nature of the political decision on levels of government debt also remains an interesting subject for research, but the factors that influence a government's capacity to borrow, and therefore delineate the range of political options, are paramount (see Frieden 1991a²²).

The second point regarding government debt's importance is that this debt represents an inter-generational transfer of resources: spend now and pay later (Allen and Gale 1994). Pension reform is an example of the political salience of such issues (e.g., Clark 2003; Engelen 2003; Tickell 2003). Indeed, the issue can be more usefully seen by political economists as one of inter-governmental transfer. A government that can borrow more has greatly increased ability to achieve its objectives, be they social programmes, war²³ or re-election. Borrowing has the added advantage of allowing relatively immediate spending by politicians focused on the short term (see Geddes 1994 on Latin American politicians' need to focus on the short term, even at the expense of long term economic

¹⁹ Source for non-EU countries (2005): Econstats. www.econstats.com/weo/V006.htm, accessed 3 July 2007.

²⁰ International commitments, such as those relating to European Monetary Union, notwithstanding.

²¹ The figures here do nevertheless raise the question of whether any other developed countries could approach Japan's very high levels of government debt without substantial economic dislocation.

²² Frieden's analysis is of Latin America 1965-1985, meaning it mainly concerns bank lending (see also Eaton and Gersovitz 1987). However, his point (1991a: 53) that 'borrowers on international markets are...' 'supply constrained' 'remains valid for emerging bond markets.

²³ Ferguson (2001: 406) concludes of the Cold War 'a crucial advantage enjoyed by the United States was the ability to finance increased arms spending by selling bonds to the public'. See also Frieden 2006: 131 on allied countries' borrowing in the U.S. during World War One.

performance). ‘Eventually the debt would have to be repaid. For a politician, however, eventually is a long time, certainly farther in the future than the next election’ (Frieden 2006: 381). This inter-governmental transfer creates the situation that a large part of the volume and structure of a government’s debt is inherited from previous governments, the importance of which is increased by the last point: virtually all government bond markets are in some sense ‘Ponzi schemes’. If governments could not refinance themselves over an extended period by issuing further debt, few would be able to repay their existing obligations without the inflationary printing of money. This is as true of the United States as it is of Lebanon, but the issue clearly has far greater salience for an emerging market government, where an inability to finance is a far more real prospect. For all these reasons, the cost of, and the ability to sell, government debt is a central means by which financial market actors can pressure governments. This is not to argue that to focus on the foreign exchange rate as the key area of analysis (e.g., Frieden 1991b; Frieden *et al.* 2000; Frieden and Stein 2000) is to concentrate on a less important variable. It remains the case that the exchange value of a country’s currency is of considerable economic and political salience.²⁴ The foreign exchange rate is therefore an equally important path for private market pressures. However, the foreign exchange market’s complexity, in particular the multiplicity of market actors, makes the sort of analysis conducted in this study very much more complex, and probably impossible given the constraints.

Consideration in IPE of financial globalisation and government policy autonomy has focused on a number of different questions. There is the question of the extent of financial globalisation, including a comparison with the period before 1914 (e.g., Hirst and Thompson 1999; Frieden 2006). This study makes no historical comparison, but the data above, and further below, show that financial globalisation can be overstated in the case of the government bond market. The increased ability to trade risk in the current episode of financial globalisation, however, would suggest an important change from the

²⁴ Frieden (1997: 86) argues that the exchange rate’s status as a measure of a government’s credibility is constructed, not inherent.

prior period. The second question, most effectively considered by Mosley (2003), but also in the extensive literature in economics and IPE on ‘push’ (i.e., international) or ‘pull’ (domestic) factors in international investment,²⁵ is what issues are of interest to international investors. Mosley suggests that investors in emerging market countries have an interest in a wider range of issues than when they are investing in developed countries (see also Grabel 1996; Armijo 2001b). That wider area includes a closer attention to politics (Mosley 2003: 128; see also Hardie and Mackenzie 2007b) Martínez and Santiso (2003: 365) consider that ‘[p]robably the most relevant definition of an emerging market is an economy where political outcomes and uncertainties...tend to have high impacts on financial variables and therefore on stock markets’ (see also Perry and Robertson 1998).

This study is not aimed at addressing this important question, but a third. This is the question of the extent of government policy autonomy to follow whatever policies they wish to undertake. Much analysis has focused on the ability of (particularly developed) countries to maintain welfare spending, but this conflates two separate issues: how much autonomy do governments have, and what issues are of interest to international investors? Although it appears reasonable to impute hostility towards high welfare spending on the part of bond market investors, Mosley’s (2003) conclusions suggest investors in bonds issued by developed countries have a very narrow focus that does not include the composition of government spending. This study seeks to avoid any conflation and considers the extent of government policy autonomy and the factors behind that autonomy separately from the question of which policies investors prefer. Autonomy for a government is therefore the autonomy to follow ‘bad’ policies as well as ‘good’. Lebanon, the case study country that it will be argued has the highest autonomy, could be considered to have followed many questionable policies.

²⁵ See Eichengreen and Fishlow 1998; Eichengreen and Rose 1998; Maxfield 1998a and 1998b; Manzocchi 2001.

Governments have the option to ignore the preferences of investors, even existing holders of a government's debt. At an extreme, that can involve ignoring the contractual obligation to pay interest and repay principal on debt, by choosing to default. In the emerging markets with which this study deals, this is relatively common. Recent examples include Argentina, Ecuador and Russia. The question is the degree to which governments feel constrained to follow the policy requirements of financial market actors. A rationalist perspective is taken here in answering this question. In IPE, similar approaches, whether focused on bond markets, international financial institution conditionality or foreign direct investment, follow, explicitly or implicitly, a 'bargaining' (Kahler 1992) or 'external incentives' model.²⁶ Some studies of European Union enlargement, although rarely considering the activities of private market actors, have employed the same model explicitly (e.g., Schimmelfennig and Sedelmeier 2005). The central argument of such models is that change will take place when governments consider the benefits of change outweigh the domestic political costs of such change. In the case of government bond markets, the change is in the cost and availability of borrowing, which can rise or fall in response to specific government policy (Mosley 2003: 15).

Because much of the analysis undertaken below considers domestic as well as international investors, the use of the term 'external' is misleading. However, the basic concept used here is very similar to the external incentives model. The greater the positive (negative) market reaction, the greater the incentive to a government to follow (not to follow) that policy. Since the alternative to borrowing is to tax²⁷ or change policy, the greater the market reaction, the lower the government's policy autonomy. Both the price and the available amount of government debt can be combined as the volume of debt (relative to the size of the economy) that a government can borrow sustainably. This is imprecise, as discussed above, because of the difficulties of estimating debt sustainability, but it is clear, in considering the case study countries, that

²⁶ See, for example, Kahler 1992; Maxfield 1997, 1998a and 1998b; Mosley 2000, 2003, 2005, 2006.

²⁷ There are obviously other non-recurring alternatives, such as privatisation, which offer a means to raise revenue.

they have markedly different borrowing capacity. Lebanon's debt may in reality not be sustainable at current levels, but even halved it would be at levels similar to Turkey after the 2001 crisis and far in excess of Brazil. Debt sustainability is dependent on a whole range of factors and assumptions (including, of course, regarding future economic performance), but a central variable which will be considered here is the loyalty of investors to government debt. As will be discussed below, different investor types exhibit very different levels of loyalty (Hirschman 1970). The more loyal an investor, the more they are likely to remain invested despite policies of which they might disapprove. The more, therefore, a government is able to borrow from these loyal investors, the higher the government's autonomy from the policy preferences of international financial actors.

The question of government policy autonomy, then, remains about government policy *choice*. The extent to which that choice is constrained is an ongoing debate within IPE (for an overview, see Cohen 1996). The degree of autonomy also has implications regarding the appropriate variables to study, exogenous or endogenous factors. Frieden recognises that 'external conditions have powerful effects' (Frieden 1988:16), but 'the principal explanatory tool is the character of socioeconomic and political cleavages within the borrowing countries' (*ibid.*:1). Bernhard *et al.* (2002) reach the same conclusion for both central bank independence (see also Bernhard 1998) and foreign exchange policy, as do Armijo (1999) for privatisation, Sobel (1994) for financial liberalisation and Bearce (2007) for monetary policy. In discussing exchange rates, Frieden concludes 'governments are almost always capable of sufficiently affecting traders' incentives to drive currencies as they wish' (Frieden 1997: 82; see also Frieden *et al.* 2000; on Mexico, Gruben 2001).²⁸ Starr (1999), discussing Mexico and Argentina in 1994-95, similarly sees the exchange rate as largely a political decision. Pauly (1995: 373; see also Pauly 1997) concludes that 'states can still defy markets' and Helleiner (1994, 1996) argues that governments can reverse the process of liberalisation they have started (see also Sobel 1999). From a different perspective, Kahler (1992) considers the

²⁸ He notes, however, that the availability of financing can be a significant constraint (Frieden 1991a).

influence of IMF conditionality on government policy to be determined largely by domestic political processes (also Krasner 1985; Strange 1998; Stone 2001²⁹),³⁰ and Sachs (1989b) notes that compliance with IMF conditionality is ‘rather weak’. Looking specifically at Latin America, Phillips (2000: 284, italics in original; see also Phillips 1999) agrees: ‘neo-liberal reform processes...were initiated *at the domestic level*’. Foucher (1999) and Kingstone (1999) similarly suggest domestic explanations for Brazil’s stabilisation efforts. Haggard and Webb (1994: 5) conclude: ‘There is no evidence ... that external actors tipped the political scales in favor of reform when the domestic institutional and coalitional environment was unfavorable’ (see also Starr and Oxhorn 1999; Gilpin 2001). Weiss (1998) shows the continuing importance of the state’s ‘transformative capacity’ for economic governance in a globalised economy. Evans (1985) similarly sees globalisation as potentially increasing demands on the state. Garrett (1998b) demonstrates the continuing policy latitude for left wing developed country governments, and the potential for state capacity enhancement (see also Weiss 2003).

Alternatively, ‘the impersonal forces of world markets...are now more powerful than the states to whom ultimate political authority over society and economy is supposed to belong’ (Strange 1996: 4; see also Strange 1998). Similar views are expressed, to varying degrees, by Drucker 1986, McKenzie and Lee 1991, Cerny 1993a and 2001, Cox 1996, Rosenau 1997, Armijo 2001b and Underhill 2001. Stallings (1992), in contrast to Kahler, considers IMF conditionality a strong influence.³¹ Epstein (1996: 212) argues ‘[c]ountries that want to attract a great deal of foreign capital are constrained to play by one set of rules’. For Gill (2000:57), liberal economic orthodoxy has produced ‘globally deflationary’ conditions, and Armijo (2001a: xiii) sees U.S.

²⁹ Stone (2001: 182) concludes, however, that ‘capital flows applied the discipline to Russian policy-makers that the IMF could not’.

³⁰ Brazil renegotiated seven IMF agreements from 1982 to 1986, each time because of failure to meet the programme’s target, and then refused to sign another in 1986 (Nau 1990: 287; see also Cardoso and Fishlow 1989).

³¹ Baer and Hargis (2000: 204) suggest that the availability of alternative sources of finance will be an important variable in determining IMF influence (see also Stallings 1992: 60).

interest rates as ‘a more powerful parameter in crafting national macroeconomic policy [in developing countries] than almost any domestic consideration’ (see also Molano 2001 on Mexico and Thailand). Haggard (1995:6) concludes ‘the willingness of developing countries [in the 1980s] to entertain the deep integration agenda can only be understood in light of powerful external economic and political constraints’. Hurrell (1990) agrees for Latin America in the 1980s (see also Gills 1997; Buxton and Phillips 1999), and Maxfield (1997) sees the need for external financing as the most important variable influencing the granting of central bank independence. Neoliberal macroeconomic policies are not the only possible result, but microeconomic policy changes also (Cohen 1996). Regulatory convergence is one possible microeconomic outcome (Holt-Dwyer 2001; Porter 2001), or ‘re-regulation’ with ‘new market-oriented rules’ (Cerny 1993b).³²

The middle ground in this debate is mostly concerned with developed country policy choice. Andrews and Willett (1997) see constraints, but a high degree of government policy flexibility remains. Garrett and Lange (1991) reach a similar conclusion on policy flexibility for left wing governments. Garrett (1998b: 787) sees ‘[p]eaceful coexistence’ not ‘collision course’. Similarly, but basing his argument mainly on regulation, Underhill (2000) suggests ‘a state-market condominium’, although he questions how long this might last. Pauly (1997: 7) concludes the IMF is ‘[m]ore important than global market enthusiasts claim and less powerful than opponents of globalization believe’.³³ The overall approach in this study accepts this middle ground, but looks at the reasons for varied policy autonomy. The work can be seen as a partial response to Cohen’s (1996: 283) conclusion that: ‘The interesting question...is not whether financial globalization imposes a constraint on sovereign states; it most clearly does. Rather, we should now be asking how the discipline works and under what conditions’.

³² Strange (1997b: 189) sees ‘a growing asymmetry of regulatory power among the governments of capitalist countries’.

³³ Pauly, however, agrees with Stone that private markets can provide discipline the IMF cannot.

The Appropriate Level of Disaggregation

The Analysis of Investor Types

The level of aggregation in this study represents a more detailed focus on different types of investor that has generally been undertaken in IPE. The choice of the level of aggregation must combine a parsimony that allows theorising and the detail that contributes to understanding. Disaggregation in the study of capital flows has been at a number of levels. The first distinguishes between foreign direct investment, bilateral or multilateral lending, and private financial flows. One conclusion from this level is a distinction between liquid and illiquid assets (for example, Frieden 1988), used particularly to distinguish between foreign direct and financial investment, but also with implications for this study. However, in analyses of domestic interest groups and international economic policy (for example in Latin America and Europe by Frieden), this approach can lead to the interests of the financial sector being treated as homogeneous (see also Arestis and Sawyer 1998). A second level of disaggregation has therefore been to distinguish within capital flows (e.g., Schonhardt-Bailey and Bailey 1995, who also consider the mobility of assets). This second level has frequently focused on differences between bank lending and portfolio flows. This disaggregation allows a clearer understanding of financial crises, particularly the role of bank lenders (Griffith-Jones *et al.* 1998; Griffith-Jones and Bhattacharya 2001; Van Rijckeghem and Weber, 2000; Radelet and Sachs 2000; Kaminsky and Reinhart 2001), but can result in overly general conclusions such as ‘I expect portfolio types of capital flows to generate the most pressure for preemptive neoliberal policy changes’ (Armijo 2001b: 40), or ‘in the particular case of developing countries, foreign investors may be especially concerned that macroeconomic policy be contractionary because of the greater perceived currency, political and inflation risk in these countries’ (Gabel 1996: 1764; Gabel is writing about portfolio investment). Such conclusions risk obscuring important differences within portfolio capital. For example, Armijo (2001b: 40) includes the removal of trade barriers as one of the possible neoliberal policies. Yet there is no *a priori* reason why an

international equity investor in a company supplying the domestic market should favour lower trade barriers. As Baer and Hargis (2000: 206) argue, 'the traditional treatment of all forms of portfolio capital in one category is misleading'. 'The market is not a unitary actor after all; we must avoid the sin of reification' (Cohen 1998: 146).

A further necessary level of disaggregation therefore distinguishes between different types of portfolio flows. Eichengreen and Fishlow 1998: 52 suggest that '[a]rguably, equity investors are more sensitive to expectations than are bondholders and banks'. Similar examples include Mosley's (2003) focus on international bond market investors, McCulloch and Petri (1998), Haley (2001) and Santiso (2003) on international equity investors. Santiso also considers emerging market bond investors. However, as the equity investor example above demonstrates, there is no reason to see disaggregation by type of investment as any more than a partial solution. Ultimately, it can fairly be argued, the issue can only be solved by a level of disaggregation which is impractical and possibly also uninformative. However, a further level of disaggregation does increase understanding. Examples of such work are Maxfield's (1998b) categorisation of different financial investor types into short and long term, impatient or patient, and relatively more or less influenced by 'push' or 'pull' factors in their investment decisions, and Haley's (2001) study of emerging market institutional investors. Such an approach still represents substantial and necessary aggregation, but achieves additional insight and highlights important policy implications (see also Maxfield 1997). As Haley (2001: 78) concludes: 'it is not only the laws of supply and demand that are impacting democratic processes, but also the conventions and preferences of institutional investors'. This study seeks to contribute to this more detailed disaggregation. I follow others in focusing on one financial product, government bonds, but distinguish investors by both 'type' (bank, individual, mutual fund, etc.) and as either domestic or international.

Such disaggregation of capital flows helps examine some of the conclusions of previous disaggregation. For example, is Mosley correct in seeing international financial actors as

having a strong influence? Mosley's measure of this strength is the movement in bond prices, which is to a large, if varying, extent the result of domestic investor decisions. Sobel distinguishes between 'intermediated' and 'disintermediated' markets, observing (1999: 24) that '[d]isintermediated markets do not have artificial floors generated by government policies. What the market will bear produces the final cost of capital in disintermediated markets'. The ways governments, central banks and other regulatory authorities (for example bank regulators) can influence disintermediated markets will be discussed below, and the distinction between intermediated and disintermediated markets is questioned by the fact that many of the largest domestic investors in both domestic and international government bonds are commercial banks (IMF 2003b: 79 notes this for local currency domestic bond markets; also Borensztein *et al.* 2006: 5). This is the case in two of my case study countries, Lebanon and Turkey. In Brazil, banks and domestic mutual funds hold approximately equal amounts of government debt (see Appendix B, Table 6).

This study can therefore be seen as in part a response to Maxfield's (1998b: 70) suggestion that:

Future success in understanding the extent and type of influence that international financiers exercise over economics and politics in emerging market countries requires the disaggregation of international financial asset holders by product and investment objective. Different classes of investors will constrain emerging market governments' policy choices differently. This is because investor motivations vary (see also Cohen 1996: 284; Sobel 1999: 22).

The required disaggregation must therefore begin with an understanding of which investors are involved, before analysing the motivations of those investors. Not only is this relevant to IPE, but it also has implications for the consideration of government policy alternatives: 'the role and composition of lenders has so far not been stressed in the policy discourse' (Van Rijckeghem and Weder 2000: 4). This approach quickly raises some important issues regarding the area of study. First, the consideration of different investor 'types' is of necessity selective, neglecting some important investors.

The selection is driven by those investors that dominate the markets for emerging market government debt. In the chapters that follow, the different motivations of commercial banks, individuals, pension funds, mutual funds and hedge funds³⁴ are analysed.

Considering Domestic Investors

An analysis of the investors that buy government debt immediately suggests a less conventional approach than is usual in IPE's study of financial markets, because the importance of domestic investors in buying government debt is clear. This will be demonstrated further below. As a result, this study seeks to move beyond the debate on the influence of 'international financial asset holders', and focus on the question of the influence of investors in general, domestic or international, on emerging market government policy autonomy. Economists have long recognised the home bias of investment. At a macro level, Feldstein and Horioka (1980, updated by Feldstein and Bacchetta, 1991; see also Zevin 1997) show the high correlation between additional saving and additional domestic investment, indicating that the majority of domestic saving in industrialised countries stays at home. Although the implications of these findings for the true level of international capital mobility remain debated (Frankel 1991, 1992), the original insight is now largely accepted (see Dornbusch 1991, though Feldstein and Bacchetta show the correlation is declining). More importantly for this research, and inadequately recognised in IPE research on developing countries,³⁵ this home bias also applies to investment within emerging market countries. In 1993-1996, for example, despite the high levels of private capital flows to emerging market countries, they financed only 25% of investment, with the remainder domestically financed (Schwartz 2000: 310).

³⁴ Hedge funds are a particular kind of mutual fund, but the differences between hedge funds and other mutual funds require separate consideration.

³⁵ An exception is the literature on capital controls and the Asian crisis, where this home bias is implicit in the suggestion that the high savings rate of Asian countries limits the need for international capital flows (e.g., Wade and Veneroso 1998).

In portfolio investment more specifically, Epstein (1996: 213) notes the ‘surprisingly low’ level of international diversification in Japan, the United States and the United Kingdom (see also Gordon and Bovenberg 1996; Sobel 1999: 14; Grahl 2001; Gilpin 2001; Davis and Steil 2001: 77). In bond market investment, Burger and Warnock (2003) find that at the end of 2001, U.S. investors held only 4% of their assets in foreign bonds (see also Burger and Warnock 2004).³⁶ At the end of 2001, U.S. investors held only 9.6 per cent of the total Latin American bond market (Burger and Warnock 2003: 9). For the emerging markets, the IMF (2003b: 77) notes that ‘public sector domestic bond issuance was nearly 13 times larger than international foreign currency bond issuance’ in 2001. Mahon, looking at capital flight from Latin America, concludes ‘especially in the countries that had large amounts of net capital flight, leaders seeking to attract capital inflows would have been well advised to worry mainly about the confidence of the *local* holders of overseas assets’ (1996: 134. Italics in original; see also Palan *et al.* 1999³⁷). It is also not unknown for an analytical distinction to be made between domestic and international investors. The existence of international investors in domestic markets has been recognised (see, for example, Khor 2000: 156 on Russia;³⁸ Baer 2001: 212 on Brazil). In addition, a distinction between domestic and international equity investors has been made, for example, by Frankel and Schmuckler 1998 in Mexico (see also Mayer-Serra 2001), and Calvo and Mendoza (2000a) argue that information asymmetries lead rational international investors to follow the activities of more knowledgeable locals (also Drazen 2000; Bikchandani *et al.* 1992; see, however, Baer and Hargis 2000; Radelet and Sachs 2000 on Asia; IMF 2003b). A distinction between domestic and international banks is also commonly made (see chapter 2).

Within IPE, and particularly in consideration of the situation of developing countries, the importance of domestic capital is less well recognised, and even less fully researched. Sobel (1999: 206) argues ‘the focus upon global markets in [IPE] detracts

³⁶ Down from 6% at the end of 1997, but still US\$502 billion.

³⁷ Palan *et al.* focus on tax havens, but discuss capital flight to these havens.

³⁸ Khor (2000: 156) claims international investors held the majority of Russia’s domestic debt in 1998, but the source is unclear.

attention from national markets. Domestic capital aggregation and allocation mechanisms continue to supply the bulk of investment capital in society. A national bias exists in every investment portfolio'. He further suggests that a 'future agenda should include further disaggregating capital to consider the relationship between different types of capital and public and private behavior' (Sobel 1999: 206; see also Kahler 1998: 10). The understanding of the activities of different investor types remains at an early stage (Kaminsky and Reinhart 2001). Cohen (1996: 288) makes a similar point, whilst also raising the possibility that '[o]ne key might lie in the distinction between national and transnational capital, which could help to explain observed differences in pressures for convergence at the sectoral level'.

Furthermore, while the presence of international investors in domestic markets is generally recognised, if still difficult to measure accurately (IMF 2003b: 88), domestic investors buying what is considered international debt has not received attention. Even in analysis of international debt compiled by the international financial institutions ('IFIs') any bond debt that is issued outside the country of the issuer is international debt, regardless of the ultimate purchaser of the bonds (see, for example, IMF calculations of Turkish external debt sustainability, which assumes incorrectly that 'securities issued abroad, e.g., Eurobonds, are held by nonresidents' [IMF 2006a: 52]). Although the figures are subject to some controversy, interview and other data presented below suggest that approximately 80-90 percent of Lebanese Republic international bonds are held by Lebanese investors, mainly the commercial banks, around 50 percent of Turkey's are similarly held by domestic investors, and possibly 25 percent of Brazilian government debt. Dooley *et al.* (1986: 286) acknowledge the importance of domestic investors in developing countries' external debt as early as the 1980s, and suggest that '[i]n some respects residents face incentives similar to small external creditors. Like other 'fringe' creditors, residents respond to economic perceptions about the course of the economy and economic policy'. The situation is that domestic investors not only dominate debt that is legally termed domestic, but are also significant, in some

countries dominant, investors in supposedly international debt (on Argentina, see Datz 2007; IMF 2003b: 80).³⁹

The work on ‘original sin’ (e.g., Eichengreen *et al.* 2002; Eichengreen and Hausmann 2005) shows the problems of borrowing denominated in foreign currency,⁴⁰ and Fry 1997 demonstrates the negative impact on inflation, saving and growth of ‘excessive’ (he suggests above 50 per cent of GDP) foreign debt accumulation. Therefore, from which investors governments choose to borrow, and in which currency they borrow, remains important. However, to understand the influence of bond market investors on government policy autonomy requires that both domestic and international investors are analysed. It also requires focus on two questions. Are there significant differences between domestic and international investors of the same type, and, if so, how do they differ? (e.g., are the motivations of Brazilian and American pension funds the same?); and, following Maxfield’s observation, what are the differences between different investor types (i.e., what are the differences between pension funds and hedge funds?).

Methodological Approach

The Interview Data

Much of this study relies on interviews with 126 international and domestic market actors and observers. A total of 39 interviews were conducted with 39 individuals in London and New York. All are involved in the market for emerging market bonds, as traders, syndicate managers⁴¹ or researchers at investment banks, or as fund managers or strategists at fund management companies, insurance companies or hedge funds.

³⁹ If a bond is issued under the legal jurisdiction of the government issuing the bond (i.e., Brazil issues a bond whose documentation is governed by Brazilian law), that bond is defined as domestic. If the governing law is other than that of the issuing country, the bond is defined as international. This is not unproblematic, as countries issue foreign currency denominated domestic bonds.

⁴⁰ Both Brazil and Turkey have borrowed US\$-denominated, or linked, debt in their domestic markets.

⁴¹ Syndicate officials are responsible within investment banks for arranging the new bond issues through which governments, and other types of borrowers, raise funds.

Interviews in London were conducted between 4 January 2005 and 16 February 2006, with the bulk of interviews conducted during four visits to London in February, June and October 2005 and February 2006. All interviews in New York bar one took place during a single visit in May 2006. Two interviews were conducted over the phone (one of which was followed by a face-to-face meeting), the remainder face to face. These interviews give the perspective of a wide variety of international financial market actors.

To analyse domestic market actors, interviews were also conducted in the three case study countries. In Brazil, 26 individuals were interviewed in 22 interviews (conducted in São Paulo, Brasilia and Rio de Janeiro, 29 August – 12 September 2006), 14 financial market practitioners (3 of whom were also former central bank officials), 7 Ministry of Finance or central bank officials or ex-officials, 3 representatives of the Brazilian Mercantile and Futures Exchange ('BM&F'), a representative of Febraban, the Brazilian bankers' association, and an academic economist. 21 interviews of 27 individuals took place in Lebanon (Beirut, 2 September - 12 September 2005, with a further interview with a lawyer involved in the Lebanese market conducted in London, 21 October 2005). 6 were Ministry of Finance or central bank officials or ex-officials, one a regulator, one a bankers' association representative, one an academic, and the remaining 18 commercial bank officials. In Turkey, 25 interviews took place with 34 individuals (Ankara and Istanbul, 30 November – 11 December 2005). Nine were with Treasury or central bank officials, or regulators. Two were with economists (one of whom sat on the central bank's Monetary Policy Committee), one with a representative of the Istanbul Stock Exchange. The remaining 22 were financial market practitioners, of whom one was a former Treasury official.

A full list of the institutions for which the interviewees worked is given in Appendix C. Two institutions are described, rather than named, at the request of the interviewee. Interviews were given on the basis of anonymity. A conflict exists between this anonymity (which was of high importance to most interviewees [see also Sobel 1994: 171]) and the usefulness of job descriptions for each interviewee. In many cases, either

the institution whose employee was interviewed is itself small, or few individuals in a large organisation perform the same job. There is only one ‘Head of Emerging Market Bond Trading’ at each investment bank, for example. For this reason, specific dates of interviews are not given in Appendix C, but simply a list of institutions. When interviewees are quoted, however, a job description of the interviewee, the type of institution for which the employee worked⁴² and the date of the interview are given. This serves to maximise the reader’s information, while preserving anonymity.

The interviews were semi-structured, based around a range of questions that varied depending on the interviewee’s job description (Sobel 1994: 171 warns against close-ended questioning of financial market actors). For investors and traders, both international and in the case study countries, questions focused on their investment activities, the influences on their investment decisions and general observations on the markets in which they operated. For government and central bank officials, the subject of the questions varied according to the responsibilities of the interviewee, covering subjects as appropriate, including the government’s borrowing strategy, regulation, market development and monetary policy. Interviews took place almost exclusively at the interviewee’s place of work and generally lasted for 45 – 120 minutes. Interviews were, where possible, recorded, with interviewees’ permission. This permission was rarely withheld, in contrast to Sobel’s (1994: 171) experience. Five interviews with international financial actors were not recorded (including two telephone interviews and another on a trading floor where recording was impractical), but relied on note taking, as did one in each of Brazil, Lebanon and Turkey. Recordings were professionally transcribed and subjected to close analysis involving multiple readings and categorisation of sections of the transcriptions by the subject matter discussed.

⁴² In the interviews in Brazil, Lebanon and Turkey, a distinction is made between ‘foreign-owned bank’ and ‘foreign bank’. This is done to allow readers to consider possible differences between existing domestic banks which are bought by foreign banks – termed here ‘foreign-owned’ – and foreign banks that have set up new operations, which I have called ‘foreign’. Foreign banks tend to be smaller operations, including some that are confined to investment, rather than commercial, banking business.

A snowball technique was employed to identify potential interviewees, but with the advantage that initial contacts were with individuals I already knew as former colleagues, clients or competitors. 22 of the interviewees in London and New York are in this category, as are 3 in Brazil, 11 in Lebanon and 4 in Turkey. Potential interviewees I already knew were obviously far more likely to agree to be interviewed (their response rate was over 90 per cent), but also were probably more willing to make an ‘active’ contribution to snowballing, including allowing their names to be used as having recommended a potential interviewee (Sobel 1994: 172 describes a similar experience). Approaching a possible interviewee using a recommendation from someone s/he knew appears to have been a significant positive influence on subsequent agreement. E mails (the main form of initial contact) were more likely to be opened with the recommender’s name in the title, a number of interviewees asked for the name of the recommender, and at least one checked on my credentials with a mutual acquaintance. Two interviewees contacted subsequent potential interviewees directly. Overall, therefore, it seems almost certain that the high response rate in this study – over 75 per cent⁴³ – (Mosley [2003: 52] achieved approximately 40 per cent in a study aimed at a similar group of international financial market actors) is the result of my background rather than any superior research methods.

A snowball technique always raises questions of representativeness (Sobel 1994: 172), and the methods employed here compound this concern. Most obviously, can a sample of international financial actors that includes 20 present or former employees of Morgan Stanley (also my former employer) be seen as representative? There was no evidence in the interview data that interviewees connected to Morgan Stanley, and/or having previously met me, responded in any different ways. Furthermore, there are several reasons to see such concerns as not sufficient to question the validity of the sample.

⁴³ An exact response rate is somewhat meaningless, as it depends on an interpretation of non-response. For example, 58 per cent of those initially contacted in Lebanon were subsequently interviewed, but two-thirds (ten of fifteen) of those contacted and not interviewed were employees of commercial banks represented by other interviewees, and another was a senior central bank employee (two other central bank officials were interviewed).

First, the nature of the interviewees: They generally hold strong opinions they are used to defending, and are unlikely to defer to an interviewer. Second, the information needed to understand the involvement in the government bond markets of a particular institution is generally available to me. Rankings of banks by assets, for example, ensured that a representative sample of domestic banks was interviewed in the case study countries, and the extent of the activities of particular international actors could be understood from a combination of their own responses, the observations of other interviewees and my own experience working in these markets. Where possible, also, interviewees I had met before were balanced by other interviewees with the same job description I had not met. So, for example, three research analysts in London and New York were previously known to me, but six were not. Such triangulation was only not possible with syndicate officials at international banks (I had previously known all four) and certain government officials in Lebanon and Turkey, where alternatives were not available.

The Decision to Interview

I am confident that I was able to interview a representative sample of both international financial market actors and the relevant actors in the case study countries. However, the choice of an interview based study rather than alternative methodologies also needs justification. This is, in part, a continuation of the discussion above regarding the appropriate level of aggregation, but is also a separate methodological question regarding both alternative and complimentary research methods. Mosley, for example, uses survey data to triangulate with her interview data. Survey data was not used for two reasons. First, response rate: Mosley (2003: 132) achieved a response rate of only 8 per cent in her survey of international investors (see Simmons 2001: 87 on low response rates to postal surveys in general). In some research this would be an insuperable problem for a survey, because of the non-random nature of non-respondents (Burnham *et al.* 2004: 99). In surveying experts concerning their own area of expertise, there appears no reason to fear that non-respondents are less or more interested or expert regarding the subject in question. However, there must be concerns regarding the

respondents in surveys that are sent to selected institutions rather than selected individuals. The risk of delegation to junior colleagues must be considered high, even if an individual addressee has been identified. Survey data in financial markets should not be rejected outright, particularly where it is used as triangulation, but in this study, able to achieve an unusually high response rate to interview requests, a survey was not considered an efficient use of limited time or other resources.

Interviews are not only attractive because of a better response rate. In some areas, interviewees were able to provide estimates of data that are not available elsewhere. The extent of domestic ownership of international bonds is only one example. However, interviews are generally a source of particularly rich data. This is as a result of both the nature of interview data, and the ability, in a semi-structured interview, to tailor the discussion to suit a particular interviewee's expertise. The fact that I am researching a market in which I previously worked also points to interviews as the best way to exploit my expertise (see Burnham *et al.* 2004: 101 on greater interviewer understanding improving interviews). The main purpose of the interview data is to explore the interests of domestic and international investors. 'An important starting point for domestic IPE'⁴⁴ is to ascertain interests, or policy preferences, of groups both broad and narrow. This can be done inductively, by observation, interviews, surveys, and other empirical techniques to map the interests of the relevant population' (Frieden and Martin 2002: 127; see also Frieden 1999). In analysing European Monetary Union, Frieden and Jones conclude '[n]ational economic interest in joining a monetary union depends as much on perceptions as on reality – on whether actors in global financial markets believe that monetary union is a good thing in general or for a particular country, as much as on whether EMU or EMU membership is a good thing in fact' (1998: 172). Such perceptions could be surmised, for example from what would contribute to the maximum profitability of domestic banks (see Armijo 1996 on Brazil). However, to explore these interests in considerable detail also requires detailed data that can only be

⁴⁴ By 'domestic IPE', Frieden and Martin mean analysis which starts with the interests of domestic interest groups, and how these are affected by international factors, and then looks at how these interests are mediated by domestic institutions.

collected through interviewing. For example, it might be possible to surmise that Lebanese and Turkish banks would favour high government indebtedness, and therefore high bond issuance, as long as the level of overall indebtedness did not reach excessive levels. Alternatively, the banks might take an equally self-interested view, that if government indebtedness falls, reducing the supply of new bond issues, the prices of the bonds they already hold would rise, increasing their short-term profits. Both attitudes could be in the economic self-interest of the investors involved, but lead to conflicting policy preferences. It is only through interviews that it is possible to understand fully the interests and actions of investors, even within a rational actor model. This will be demonstrated in the chapters that follow.

The Use of Country Case Studies

The other primary methodology employed in this study is the use of three case studies: Brazil, Lebanon and Turkey. The use of case studies, their number and identity all require justification. The case study approach is in sharp contrast to the large-n studies that predominate in the consideration of the interaction between emerging market governments and globalised financial markets. A large-n approach in emerging markets is in marked contrast to much of the study of the same interaction involving developed countries. The varieties of capitalism literature (Zysman 1993; Hall and Soskice 2001), for example, is, by definition, based on a number of varieties. Small European countries are also considered to require separate analysis (Katzenstein 1985; Kurzer 1993). Within the IPE of developing countries, however, regional studies or higher levels of aggregation dominate. The data in this study demonstrate that emerging market countries are not even similar in which types of investors mainly own their bonds, highlighting the difficulties with such an aggregated approach. Further important differences between the case study countries will be discussed in detail below. Of course, as with all case study approaches, any generalisations of the conclusions must be suggestive only, and await further research into more cases, but the detail of the case studies will provide the basis for such broader study. If data deficiencies can be

overcome, this further research could also include a more quantitative approach than has been taken here.

Stake (1998: 88) divides case studies into three different types. An intrinsic case study is 'undertaken because one wants a better understanding of this particular case'; an instrumental case study 'is examined to provide insight into an issue or refinement of theory'; collective studies 'study a number of cases jointly in order to inquire into the phenomenon, population, or general condition'. It is possible that a number of case studies can be both collective and instrumental. Any case study can have value as an intrinsic study for those with particular interest in a country or region (Blaikie 2000: 219). However, this is not my motivation in making choices regarding case studies. A larger number of case studies could, of course, create an analysis with higher typicality and ability to generalise. This approach would also fit more closely with much of the aggregated analysis in IPE studies of emerging market countries. Within the constraints of a PhD, it could possibly be achieved by reducing the amount of research in each case study.

I rejected such an approach for a number of reasons. An approach that sought to prioritise typicality and ability to generalise across such a disparate group of countries immediately runs the risk of more case studies and a decreasing level of detail in each case. I have deliberately chosen an 'emphasis on knowledge in depth ... at the expense of being able to make generalizations about the phenomenon as a whole' (Burnham *et al.* 2004: 31). The relevance of the detail in the following chapters will, I hope, serve to justify that decision. Even if the wider approach could be used, case studies still do not give the opportunity to generalise with total confidence, and each case remains unique (Burnham *et al.* 2004: 53). I would have risked losing the greater understanding of a small number of case studies for only a partial gain in generalisability. The approach chosen, therefore, is for instrumental case studies, aimed at providing insights into three government bond markets. I believe that the conclusions reached do have general application across emerging market countries, but increasing confidence in such a view

must await further research. Any generalisation must be cautious. Indeed, one of the conclusions from this study must be that there are substantial variations in countries' circumstances, and therefore in the impact of financialisation.

The Choice of Case Study Countries

The choice of Brazil, Lebanon and Turkey as the three case studies must also be justified. In considering this question, it is first necessary to consider the degree to which this is a comparative study aimed at isolating a factor or factors for analysis, and at identifying, as far as possible, causal inferences. 'The comparative method is about observing and comparing carefully selected cases on the basis of some stimulus being absent or present' (Burnham *et al.* 2004: 60). The 'stimulus', the independent variable, in this research, is the level of financialisation of the government bond market, and the dependent variable is the degree of government autonomy from the policy preferences of international financial actors. In choosing my case studies to analyse this research question, '[t]here are two basic comparative research designs: most similar research designs and most different research designs' (Burnham *et al.* 2004: 62). The logic of the 'most similar' approach is that 'the more circumstances the selected cases have in common, the easier it is to locate the variables that do differ and which may thus be considered as the first candidates for investigation as causal or explanatory variables' (Castles, quoted by Burnham *et al.* 2004: 64). In other words, for this research project, I should have sought case studies which are as similar as possible in all areas (in terms of 'spurious' or 'intervening' variables such as size of economy, percentage of the EMBI, etc.) as possible. In a 'most different' approach, '[t]he logic ... is that if the independent variable has an effect on the dependent variable, then it should have the same effect despite the cases being so different when it comes to the spurious and intervening variables' (Burnham *et al.* 2004: 64).

Practical and theoretical considerations pointed me to this 'most different' approach. On the practical side, given my limited number of case study candidates, and high number

of possible spurious or intervening variables, following a ‘most similar’ approach is unlikely to be successful, becoming little more than a ‘vaguely similar’ approach. I have aimed in what follows for ‘descriptive inference’, which is ‘about systematic description of selected cases, and on the basis of that an inference may then take place in terms of what other cases might look like, or be like’ (Burnham *et al.* 2004: 143). The conclusions in this regard must be careful, but such inference is central to the case studies being more than intrinsic.

The case study countries are considerably different on many variables, including size of economy, debt-to-GDP and geographic position⁴⁵ (although Turkey and Lebanon are almost neighbours, Turkey is not generally seen by bond market investors as part of the Middle East). The three case studies also have different levels of importance to international investors, if this is measured in terms of the EMBI bond index discussed above. However, since the question I am testing is the extent to which the level of financialisation influences government policy autonomy, the independent variable used in selecting case studies was that level of financialisation. Very different levels for the independent variable allow exploration of the relationship under different circumstances. Lebanon has a relatively low level of financialisation, and Brazil a high level. As will be discussed, many international interviewees saw Brazil as in some ways, the most financialised (i.e., the easiest to trade) government debt amongst the emerging markets. Turkey lies between the two. The choice of case studies therefore fits the ‘most different’ approach that is appropriate to this study.

Investor Policy Preferences

By not following those researchers (such as Mosley 2003) who ask what policies interest investors, while considering both domestic and international investors, this study makes a basic simplifying assumption regarding investor policy preferences: namely that all

⁴⁵ Kamin and von Kleist 1999 suggest a regional variation in the spreads of emerging market bonds, with Latin American and Eastern European issuers paying higher spreads than Asian and Middle Eastern.

investors have the same policy preferences. Broadly speaking, I see actors as rationally analysing their self-interest, and seeking by their actions to maximise the achievement of that interest. In the case of financial market actors (international and domestic investors), this interest is, I assume, economic self-interest, or profit maximisation. This is controversial within a rationalist / constructivist debate, and there are parts of the data presented below that might alternatively be interpreted from a more constructivist perspective. For example, is the home bias of some investors (possibly most obviously individuals) driven by nationalist/patriotic feelings of loyalty, rather than a rationalist explanation? Home bias may also be the result of ‘deeply rooted national distinctiveness’ (Sobel 1994: 17) or simply higher cross-border transaction costs (*ibid.*: 18). ‘[D]eeply rooted national distinctiveness’ raises the possibility that domestic investors see their interests in non-profit maximizing terms, and that a rational choice approach may not represent a complete analysis. Similarly, shared ideas could explain domestic and international investors acting in a similar manner, or the spread of neo-liberal policy choice; ‘ideas, *as well as* interests have causal weight in explanations of human action’ (Goldstein and Keohane 1993:3. Italics in original. See also Haas 1980; Hall 1989; Haggard and Kaufman 1992). I do not engage to any meaningful degree with the rationalist / reflectivist or constructivist debate (see, for example, Keohane 1988), or consider in detail neo-Gramscian approaches (Augelli and Murphy 1988; Cox 1996; Gill 1990, 1993 and 2000; Gill and Law 1989). Similarly, the question of ‘epistemic communities’ (as in Haas 1999, for example; see also Kahler 1992⁴⁶) is not central to this research project. Rather, Maxfield’s (1997: 49) view that ‘[t]he impact of economic ideology on politicians’ perceptions of the need for creditworthiness is secondary to material conditions manifest in financial markets’ is followed.

⁴⁶ Helleiner 1994: 199 sees this approach as fitting the case of central bankers poorly, although Epstein 1989, cited by Helleiner 1994: 201, sees them becoming increasingly like transnational epistemic communities.

Constructivist explanations are acknowledged where they may be appropriate,⁴⁷ but there are problems with constructivist explanations of some data presented here. First, feelings of patriotism (an obvious potential difference between domestic and international investors), if they are a factor, appear either to be variable across the case study countries, or to result in very different outcomes. Lebanese and Turkish investors demonstrate far higher confidence that their government will not default than international investors, but Brazilian investor actions have in recent years demonstrated generally higher pessimism than their counterparts in other countries. In both Lebanon and Turkey, increased dollarisation of bank deposits (i.e., switching from local to foreign currencies) is a common response to uncertainty. In Brazil, this option is not open to individuals. A constructivist approach to the investment activities of institutions also faces difficulties. Institutional activity represents investment on behalf of someone else, and it appears reasonable to assume that investment is undertaken in as rational a manner as possible. The aim of investment is to maximise returns. Although behavioural finance in particular demonstrates many ways in which investors might not be totally rational, such rationality remains the most useful analytical assumption. In addition, there is the problem, when dealing with loyalty by institutions engendered by patriotism, with being able to analyse who or what (for example, an individual or an investment committee) is making the investment decision, and the influences upon them. For example, how should a Turk working for an American investment bank be considered? For all these reasons, the focus is on rationalist interpretations that can fully explain the differences between investors.

Voice, Exit and Loyalty

A rationalist explanation of the actions of financial market actors that does not accept the idea of perfectly efficient markets will almost inevitably look to the literature on transaction costs, including information costs (for example, Calvo 1996; Maxfield 1997:

⁴⁷ Frieden, in considering EMU, acknowledges non-rational influences, such as Germans' greater antipathy to inflation, but, as they are 'more impressionistic than directly observable' (Frieden and Jones 1998: 175), leaves them as acknowledged but unincorporated within the overall analysis.

145; Calvo and Mendoza 2000a; Mosley 2003). Loviscek and Crawley (1996, cited by Maxfield 1998a: 1209) argue financial markets in developing countries are not as ‘informationally efficient’ as those in developed countries.⁴⁸ Investors’ rationality is assumed in this study to be ‘bounded’ (Simon 1955) by their ‘cognitive limitations...of both knowledge and computational capacity’ (Odell 2002: 169). However, one of the significant differences between investors is in varying transaction costs, particularly the costs of exit. This study therefore makes considerable use of, as well as suggesting additions to, Hirschman’s (1970) well-known theory of exit, voice and loyalty, as a framework for considering the differences between different investor types.

The use of Hirschman’s ideas in discussions of financial markets is common (e.g., Cohen 1996: 285; Pollin 1998;⁴⁹ Cutler *et al.* 1999; Cerny 2001; Santiso 2003). The focus of such studies is on variations in voice and exit, with the two seen as alternative courses of action. An investor, faced with an actual or prospective government policy with which s/he disagrees, chooses either to express that disagreement to the government, or to sell their investment. Cerny (2001: 23), for example, sees greater linkages with international markets increasing the opportunities for domestic financial actors to exit, and therefore reducing the incentive for voice. In contrast, Armijo (1996) and Maxfield (1990) – in Brazil and Mexico respectively – show how the threat of exit increased the efficacy of voice. Cosh *et al.* 1997 and Grahl 2001 see a general decline in the choice of voice over exit among investors. The data discussed below suggest that, in these government bond markets, the developments identified in all three case studies have reached the point where, in general, the idea of voice and exit as viable alternatives for investors is no longer useful. International investors all agreed that they had no voice with government regarding policy. Interviewees either felt it was not their role to make representations to government regarding policy (aside from specifically regarding borrowing strategy such as which market to access or the preferred maturity of

⁴⁸ This literature develops the original considerations of the problems of uncertainty in markets (Akerlof 1970).

⁴⁹ Pollin sees the key difference between financial systems not in bank-based or market-based structures, but in whether voice or exit dominates, ‘dedicated’ or ‘fluid’ capital systems.

borrowing), or felt that even if they did make such representations, it would have no impact. Amongst domestic investors, only Lebanese banks attached any importance to their ability to voice concerns as a disincentive to exit. The most important reason for not choosing voice over exit was that even if it could have an impact, voice took too long to deter exit (Santiso 2003: 23).⁵⁰ This analysis therefore eschews any consideration of avenues for the expression of voice, whether through public or private sector organisations (see Porter 2005), or less formal routes such as individual meetings.

This should not be seen, however, as suggesting that voice is unimportant. Rather, at least in the markets considered here, the nature of voice has changed.⁵¹ Voice, as exercised by the IMF or a bilateral government lender, is formally expressed in the conditions attached to a loan, and readily observed. Voice, in a government bond market, is amorphous, but comes together in a single message, the price of borrowing: ‘The thing about the markets, and this is where the market is different from the official sector, is that we just deal on a price basis, we don’t make conditions... whereas the official sector make conditions but the price is the same for everyone’.⁵² As discussed above, the market’s reaction to policies manifests itself in the price at which a government can borrow, and voice comes from this cost (Mosley 2003: 17). Crucially for the importance of the increased ability to exit, the threat of exit results in greater constraint on government, even without politically-organized voice (Haggard and Kaufman 1989: 268; see also Cohen 1998) or actual exit (by domestic financial actors, Maxfield 1990; Armijo 1996; by international, Balaam and Veseth 2001). In other words, the important variable is the ability to exit.

In contrast to voice and exit, loyalty is rarely considered in the literature. When it is included, it is either dismissed as almost non-existent (e.g., Santiso 2003: 24) or only

⁵⁰ For example, emerging market bond trader, London, interviewed 17 February 2005.

⁵¹ It may well be that this observation does not hold elsewhere in financial markets. ‘Activist’ hedge funds, for example, which buy equities and then agitate for change at a company, have an investment strategy largely predicated on the effective use of voice.

⁵² Fund manager, London, interviewed 18 October 2005.

important if enforced by government regulation (Cohen 1998). To see loyalty in financial markets as nothing more than the result of government regulation has the effect of subsuming loyalty within an overly-narrow consideration of exit. Investors are seen as loyal only to the extent that they are forced to be. This thesis has taken a different approach, and one more suited to the analysis of modern financial markets. Loyalty is given far greater consideration. Prioritising a consideration of loyalty is not to deny the importance of exit, but serves to emphasise a number of important points that run throughout the study. The first is to see exit in far broader terms than the IPE literature has to date (Maxfield 1998b being a partial exception). The inability to exit can indeed ‘enforce’ loyalty, but an analysis that focuses on loyalty rather than exit serves to emphasise that the decision to exit is far more nuanced than simply regulation. In particular, a strong emphasis in this study will be on ways in which the nature of the different investor types engenders different levels of loyalty. Different investors have different reasons for investing in government bonds: individuals look for an alternative to their bank deposits, pension funds aim to match long term liabilities, and hedge funds maximise short term gains. As will be discussed, regulation is part of the reason for these differences, but only a part.

A focus on loyalty, as discussed by Hirschman, also allows consideration of different types of loyalty. In addition to loyalty enforced by the high costs of exit, Hirschman also considers another, potentially more influential, conception of loyalty, where ‘the member continues to care about the activity and “output” of the organisation *even after he has left it*’ (1970: 99. Italics in original). Hirschman sees two conditions for this; ‘exit of a member leads to a further deterioration in the quality of the organization’s output’ and the ‘member cares about the deterioration *whether or not he stays on as a member*’ (*ibid.* Italics in original). This is rational when ‘full exit is impossible; in some sense, one remains a consumer of the article in spite of the decision not to buy it any longer’ (*ibid.*: 100. Italics in original). The fact that exit leads to further deterioration suggests it will be rare that such a conception of loyalty can apply to an investor in a government bond market, because the investor must be large enough for exit to cause that

deterioration. The investor must be a ‘quality-maker’ (*ibid.*: 99). As will be discussed, such ‘quality-makers’ nevertheless exist, particularly among the large domestic banks that are such important investors in many emerging government bond markets, including Lebanon and Turkey. Furthermore, for commercial banks, ‘full exit is [almost always] impossible’.

How, then, would loyalty manifest itself in behaviour by investors in government bonds? Obviously, loyalty ‘makes exit less likely’ (Hirschman 1970: 77). A more loyal investor is less likely to sell their bonds in the event of unwelcome government policy. Increased loyalty therefore leads directly to increased government policy autonomy. This result of increased loyalty is certainly central to the analysis in this study, but in modern financial markets, it is also necessary to have a broader conception of exit. Exit includes hedging, which is increasingly possible in a more financialised market. Importantly, exit must also include a decision not to reinvest at the maturity – the date of repayment – of a government bond. This observation points to an important contribution to our understanding of financial markets that can be made by a consideration of loyalty. The greater the loyalty of an investor, the higher the likelihood of not selling a government bond, and of reinvesting the proceeds of a maturing bond. Therefore, an investor with high loyalty who invests in short maturity government bonds but is likely to reinvest at maturity (for example, an individual) does not, it will be argued, constrain government policy autonomy as much as an investor that buys longer maturity bonds but could sell or hedge those bonds at any time (for example, a hedge fund). Such an observation is at odds with an approach, usual in analysis by the IFIs of debt dynamics, that sees all investors as equally loyal (or, perhaps more accurately, not loyal at all), and focuses on the maturity profile of government debt, and therefore the need to refinance. In extreme situations, such an approach is clearly accurate. The argument regarding loyalty made in this study is not that it is, for any investors, absolute, unless enforced by draconian and watertight regulation. Investors almost invariably have the option not to invest. However, the focus on financial crises in the analysis of emerging market countries and financial globalisation, while natural, can obscure consideration of periods

when crises could have occurred but did not. ‘Why did a crisis not occur?’ is potentially as useful a question as ‘Why did a crisis occur?’ (for an analysis that ask the former question in the case of Lebanon, see Barakat 2003). In examples given in this study, it will be suggested that the answer to that first question can lie in the loyalty of particular types of investor and the financialisation of the government bond market in the country in question.

There is a second area of (increasingly common) financial activity which makes an analysis based around loyalty rather than exit more appropriate, although needing a broadening of Hirschman’s approach. This financial activity is shorting. Taking a short position, selling a security one does not already own, is clearly not exit; nor is it the same as retaining an investment in the expectation of the price of that investment rising. The investor retains an interest in the performance of the security, but it is an interest in the price falling. I have termed this *disloyalty*. The ability to express disloyalty represents a significant increase in financialisation in a government securities market, and reduction in government policy autonomy. Investors that can short have the potential ability to exert significantly more downward pressure on government bond prices, and therefore upward pressure on the government’s cost of borrowing, than investors that exit.⁵³ Of course, a short position must be ‘covered’ (i.e., the bonds originally sold bought back) at some unknown future point, but by that time the damage may have been done, especially in a crisis situation. For these reasons, Hirschman’s ideas, when applied to modern financial markets, should be updated to voice, exit, loyalty and disloyalty.

An Alternative Explanation? Financial Repression

This study is not a work of economics, but of international political economy. However, one area of economics must be considered in advance as an explanation for the level of government policy autonomy and a challenge to the originality of the claims made: the

⁵³ As with exit, the possibility of shorting can act as a constraint without the activity actually taking place.

literature on financial repression. This would suggest that the explanation for the varying levels of debt the case study governments are able to borrow is to be found in the McKinnon-Shaw analysis (McKinnon 1973; Shaw 1973) and its successors (for an overview, see Fry 1995; Demirgüç-Kunt and Detragiache 2005; Stallings 2006: 22). In the financial repression analysis, restrictions on the activities of the financial sector serve to create artificially high demand for government debt (also Maxfield 1997: 45). As with the focus in IPE on regulation, loyalty is entirely enforced. The resultant gains to government revenue can be seen as a form a taxation, yielding on average 9 per cent of government revenues (Giovanni and De Melo 1993). However, keeping interest rates at artificially low levels discourages saving and as a result lowers growth (see also Roubini and Sala-i-Martin 1992). Since higher growth increases borrowing capacity, this argument suggests, the budget constraint that is at the heart of limits on government policy autonomy is eased by liberalisation (Fry 1997: 31), turning the arguments in this study on their head:

[V]oluntary market financing of government deficits provides, paradoxically, the cheapest form of financing for the government in the long run. Cheap finance...through financial repression is a mirage...the advantages of cheap credit disappear as soon as the costs of inflation, higher interest rate spreads for the commercial banks and lower central bank profits are recognised. Perhaps the most important benefit [of liberalisation] is that, by accelerating economic growth, a move to voluntary domestic financing reduces the deficit that has to be financed (Fry 1997: 132).

In other words, financialisation, as I have defined it, increases government policy autonomy rather than decreasing it. It is a view that, in part through its adoption by both the IMF and the World Bank, has had considerable influence on policy in both developed and developing countries (Fry 1995: 389). More recently, it underpins the view that not only should deposit rates be set freely in the market, but markets generally should be as free as possible (Stallings 2006: 22). The two arguments are, however, distinct. This distinction is the central reason why the arguments regarding financial repression should not be seen as an alternative explanation for the differences between the case study countries. The original McKinnon-Shaw arguments are concerning severe

financial repression of the banking system, resulting in negative real interest rates.⁵⁴ None of the case study countries fits this analysis. Rates are positive in all three. The financial systems are therefore, to varying degrees ‘restrained’ rather than ‘repressed’ (Demirgüç-Kunt and Detragiache 2001: 98). Although it can be argued that this is simply a matter of the extent of repression, it is nevertheless an important distinction. The lifting of repression, and the resultant move to positive interest rates, may not have the same consequences as any subsequent easing of restraint. The relevance of the analysis of financial repression to this study is the question of whether the McKinnon-Shaw conclusions regarding the negative consequences of severe repression can be taken as justification for more extensive liberalisation of financial systems in general and government bond markets in particular.

Contributions to this debate certainly question how far the lessons of McKinnon-Shaw can be taken. Demirgüç-Kunt and Detragiache (2001: 121), for example, conclude that ‘[o]ne way of reading these [i.e., their] findings is that, once financial sector reforms are carried out to secure positive interest rates, steps toward further liberalization may not necessary [sic] yield gains that offset the negative impact of increased fragility’. In other words, McKinnon-Shaw can be correct, without the conclusion that further financialisation is to be encouraged. Similarly, Stallings (2006) points to the history of financial liberalisation followed by financial crash (see also Diaz-Alejandro 1985; Palma 2003; Demirgüç-Kunt and Detragiache 2005), and, importantly for this debate between repression and growth, outlines the enormous cost in lost GDP of such financial crises. Stallings analyses financial liberalisation of the domestic market, separate from

⁵⁴ Even at the heart of the McKinnon-Shaw policy recommendations, the freeing of deposit rates, concerns have been raised regarding the consequences of too much competition between banks (Hellman *et al.* 2000; Hohohan and Stiglitz 2001; see also Allen and Gale 2000; Beck *et al.* 2003 disagree). Eichengreen and Arteta (2002) identify the liberalisation of deposit rates as one of three econometrically robust causes of emerging market banking crises. In addition, Fry (1997: 88), in a large study, concludes that ‘growth is maximised when the real interest rate lies within the normal range of, say, -5 to +10 percent’, suggesting that restraint, if it led to abnormally high real interest rates, could also be damaging to growth. From a political economy perspective, Lee and Haggard (1995) conclude that repression can, in certain circumstances, result in higher growth and efficiency. Welch (1993: 41), on Brazil, concludes that ‘financial liberalisation will not necessarily achieve efficiency objectives, let alone stabilisation objectives’.

internationalisation. Prasad *et al.* (2004; see also Kose *et al.* 2006), however, similarly point to the lack of any robust causal link between financial integration (i.e., internationalisation)⁵⁵ and growth, although it must be recognised that they are certainly not suggesting any negative correlation (see, however, Chang and Grabel 2004).

Stallings (2006: 23) also makes the important point that we should ‘not conceive of the process as a dichotomous choice between repression or liberalization, but as a range of possible points on the spectrum’. There are no serious advocates of complete liberalisation (if that can be defined), with the importance, for example, of prudential regulation, particularly of banks, as a prerequisite of successful liberalisation (Fry 1995, 1997). Furthermore, ‘[e]xperience indicates that, while financial repression may be growth-inhibiting, financial liberalisation in the absence of a sustainable fiscal balance, adequate prudential regulation and, where necessary, the restructuring of insolvent financial institutions may simply be a leap out of the frying pan into the fire’ (Fry 1997: 81; also Fry 1995; Kose *et al.* 2006; Stallings 2006 suggests a more general ‘macroeconomic stability’ is essential⁵⁶). The requirement for a sustainable fiscal balance is particularly pertinent to this study. The need for a fiscal balance to be sustainable, at least in the medium term, can be regarded as little more than a truism. However, the enormous disparity in the levels of government debt, and the difficulties of definitively prescribing a sustainable level, point to the fact that sustainability is the result of a number of varied influences. Financialisation, I argue, is one. In addition, the recommendation that a sustainable fiscal balance should precede financialisation could, given the difficulties of defining sustainable, be taken as a recommendation simply for reduced government borrowing. This would mean that, prior to liberalisation, it is recommended that a government should follow at least one of the neoliberal policy recommendations. The necessity of a reduction in any fiscal deficit (and the

⁵⁵ The debate on financial integration and emerging capital markets has been mainly concerned with the freeing of capital controls (e.g., Stiglitz 2002a; Stiglitz 2005; Grabel 2003a and b; Prasad *et al.* 2004; an exception is Stallings 2006).

⁵⁶ Chang and Grabel (2004: 19) make the related point that international capital flows to high growth countries, reversing the neoliberal view of causality, so that developing countries ‘must...institute policies that initiate a sustainable growth path as a precondition for private capital inflows’.

accompanying reduction in borrowing) is a constraint on government policy autonomy. Should a government choose not to make such a reduction, there could be, under certain circumstances, ‘an optimal degree of financial repression’ (Bencivenga and Smith 1992).

Although the McKinnon-Shaw arguments in favour of the efficiency of investment can be applied to capital market systems, there is no contradiction between an acceptance of McKinnon-Shaw and the debate on the financialisation of capital markets in general and government bond markets in particular. There are two aspects to the latter debate. The first regards whether it will lead to increased growth and reduced fragility, or the opposite. The second, and the more directly relevant to this study, concerns the government’s ability to borrow. This debate accepts that financial liberalisation will lead to faster growth in the economy, increasing a government’s ability to tax and borrow even if the tax-to-GDP and debt-to-GDP levels remain constant. However, the question is whether the increased growth will compensate for the reduced government borrowing required for sustainability in a highly financialised system. Fry (1997: 31) highlights the dilemma, even when the starting point of his analysis is the less contentious move away from high inflation and negative real interest rates, not subsequent liberalisation:

Conceivably, policies of price stability and financial liberalisation could pay for themselves. If it raised the growth rate by 4 percentage points, abandoning an inflation tax that produced revenue equal to 2 percent of GDP would exactly pay for itself... Were financial liberalisation also to increase growth by 4 percentage points, exactly the same result could occur even if the real interest rate increased from 1 to 5 percent. These examples are undoubtedly wildly optimistic in most cases.

A rhetorical question serves to emphasise this point, and the potential policy dilemma for governments. If, as a precondition for successful increased financialisation, Lebanon were to cut its debt-to-GDP ratio from 175 per cent to a still-high 100 per cent, what is the necessary growth rate at which such increased financialisation leaves the (inflation-adjusted) absolute volume of government borrowing unchanged?

The Structure of this Thesis

This study examines the causal links between financialisation and government policy autonomy. By outlining many of the processes that increase financialisation, the study seeks to demonstrate the level of financialisation of different investor types, and how that level changes over time. The levels of financialisation of the government bond markets of the case study countries are also analysed, and the processes of change in the markets. The overall financialisation of a government bond market is a combination of both the financialisation of the market structure, and of the financial market actors active within it, that together determine the ability of the financial actors in the market to trade risk. This overall level is the result of the balance of the financial actors, and the ability to trade risk of the investors that dominate the particular market. As will be seen, the dominant investors are not the same in each of the case study countries. I then suggest how this financialisation is linked to government policy autonomy through loyalty. The more financialised the investor, the lower their loyalty, and as a result the lower the government's policy autonomy.

An unfinancialised system in this study is one dominated by domestic banks that lend to the government directly.⁵⁷ I start therefore with an analysis of domestic commercial banks in the case study countries. In each country, however, two of the very first stages in financialisation have long occurred: the initial development of a government debt market and the entry of foreign banks, either through buying banks or by starting up operations. Chapter 2 therefore focuses on domestic banks as buyers of government bonds, both domestic debt and international, and considers ways in which the entry of foreign banks increases financialisation. Subsequent chapters then analyse the various investor types that can become active as investors in government bonds, in order of those investor types' level of financialisation. Chapter 3 considers domestic individual

⁵⁷ There are clearly levels of financialisation below this, for example in the absence of a functioning banking system.

investors, chapter 4 domestic institutional investors (pension funds, mutual funds and hedge funds) and chapter 5 international investors, concentrating on institutions. Each chapter seeks to analyse the level of financialisation of the different investor types through their activities as investors in government debt, and the processes of change in that level of financialisation. It should be emphasised at this point that it is not argued that the process of financialisation is in any way inevitable, or that countries follow a single path. Financialisation is contingent on a number of influences that will be discussed. Government policy – its ability to enforce loyalty – remains important, but other factors will also be analysed, suggesting that enforced loyalty is not the only influence on investor behaviour.

The relationship between financialisation and government policy autonomy is discussed throughout in the context of an ‘autonomy curve’. Chapter 6 concludes by presenting in detail this curve, which links financialisation (on the x axis) with government autonomy from the policy preferences of international investors on the y axis (see page 208). The shape of this curve is outlined in detail then, but is important to note by way of introduction that this curve does not simply slope downwards from left the right. The argument presented in this study is not that there is a simple straight-line relationship between financialisation and government policy autonomy, as is implicit in some studies of financialisation and of financial globalisation. Rather, this study argues that the autonomy curve is in fact humped. Government policy autonomy is high in a market dominated by commercial banks, as would be expected from the financial repression/restraint literature, but as financialisation increases, with individual investors directly purchasing government bonds and particularly with the development of (relatively unfinancialised) pension funds, so government policy autonomy increases. At this point, it will be argued, governments are reliant for their financing on relatively loyal investors, and so have high policy autonomy. It is only as financialisation increases, both through the entry of new financial market actors, including hedge funds, but also as a result of the increased financialisation of existing investors (as a result of processes which will be analysed), that government policy autonomy decreases.

This study will then conclude by considering the implications of the autonomy curve, its shape and the reasons for movement along it, for: the use of Hirschman's 'voice, exit and loyalty' in the study of financial markets; for the study of financial markets more generally in IPE; for the question of government policy autonomy in the face of financial globalisation; and lastly the implications of the autonomy curve for government policy towards financial liberalisation.

Chapter 2

Domestic Commercial Bank Investors

Introduction

The first group of investors this study will consider in detail is domestic commercial banks. As already discussed, a stark distinction is frequently drawn between bank-based and capital market-based financial systems; too stark a distinction, this chapter will suggest, when we consider government bond markets. Commercial banks have traditionally been amongst the largest market actors in domestic government bond markets, particularly in emerging markets, as buyers of securities (either enforced through regulation or as the result of voluntarily-taken investment decisions), as market makers, and as distributors of securities to other investors. Their investment decisions are therefore of central importance to a government's ability to finance its activities. Institutions seen as commercial banks also vary greatly in their activities and business strategies, with implications for their financialisation. As will be discussed in this chapter, banks can concentrate on the buying of government securities, or prioritise lending to the private sector. They can also seek to make money from the trading of bonds rather than long-term investment.

Chapter Structure

The importance of domestic commercial banks as purchasers of government debt, even international, suggests that both financialisation and internationalisation in the three case study countries is potentially overstated. However, it is also necessary to demonstrate that this has implications for government policy autonomy, through an analysis of commercial banks as investors different from other types of investors, domestic and

international. This chapter will therefore focus on three arguments regarding domestic banks, which will then begin to answer the overall research question regarding the connection between financialisation and government policy autonomy.

Three key arguments will be made:

Domestic commercial banks have limited (but across the case study countries, varied) ability genuinely to ‘exit’, either a government debt market itself, or their exposure to the consequences of a government debt default.

This inability to exit induces greater ‘loyalty’ on the part of domestic commercial banks (and in certain cases a particular type of loyalty), with consequences for their behaviour as investors.

The differences between the three countries studied, in the ability of banks to ‘exit’ and in the resultant ‘loyalty’ they demonstrate, is the consequence of the financialisation of the government bond markets.

The chapter will take these three arguments in turn, and then consider the impact of internationalisation on financialisation, before concluding.

Domestic commercial banks have limited (but across the case study countries, varied) ability genuinely to ‘exit’ either a government debt market itself or their exposure to the consequences of a government debt default.

Commercial banks inability to exit a government debt market is the result of two separate facts. First, the banks’ large existing exposure to government bonds, both in absolute terms but also relative to the capacity of the market to absorb their selling of bonds or hedging of their exposure. Second, their exposure to the overall economy, and therefore the indirect consequences of a government debt default. This section will

examine first the extent of commercial banks' exposure to the government in the three countries, by examining a breakdown of consolidated assets, thereby demonstrating how high this exposure is. Then the percentage of government bonds the banks own will be analysed, to consider whether the banks own such a high proportion of government bonds that they are unable to exit.

Commercial Bank Exposure to their Government

In the case of Lebanon, the overall exposure of the banks to the government is high. The assets of the commercial banks, as of end April 2006, are set out in Appendix B Table 1. Of the total assets of the Lebanese banks, 54 percent are either claims on the public sector (of which nearly all are holdings of government securities) or deposits with the central bank.¹ Since 2002, the direct holdings of government securities has fallen, but this has been matched by an increase in deposits at the central bank (Banque du Liban), which are often on-lent to the government. There is debate within and amongst the banks as to whether the central bank credit risk can be seen as superior to the government or not. The consensus among interviewees was generally that the central bank's foreign currency reserves and the accounting advantages of holding certificates of deposit (CDs) issued by Banque du Liban made central bank risk more attractive. However, the IMF, while acknowledging the views of '[s]ome market participants' (2006d: 8), concludes (2006d: 9) that '[i]n a systemic sense, the distinction between central bank risk and government risk is less clear'.

This would suggest that deposits with the Banque du Liban should be considered as exposure to the government. Regardless of the view taken in this debate, however, the Lebanese banks' exposure to their own government is extremely high. In answer to the question as to whether a default by the government would lead to the collapse of the banking system, some interviewees argued that it would not. However, the majority of

¹ The figure varies generally from 54 – 57 percent (senior official, Association of Lebanese Banks, interviewed 12 September 2005). See IMF 2006d: 9 for a breakdown as of end December 2005. However, the IMF percentages add up to well over 100.

expert opinion interviewed was that this would indeed be the case. ‘If the government defaults, we default, we fail’.² Even if banks decide to limit their risk on the government, their exposure to the Lebanese banking system and the economy would leave them with effectively the same risk.³

In Turkey, the situation is slightly different, with a more even distribution of assets. However, exposure to the government securities market remains similarly high. The assets of the banking system (as of end December 2005) are set out in Appendix B, Table 2. The exposure to the government is approximately 51 per cent, slightly below the Lebanese figure. Including deposits at the central bank, this rises to 56 percent. However, as the central bank no longer lends directly to the government in the case of Turkey, this may be less appropriate.⁴ Interviewees disagree as to whether a government default would lead to a total collapse of their bank, but at least some consider that diversifying to lending to the private sector offers no protection.⁵

In Brazil, the assets of the commercial banks (as of October 2006) are as in Appendix B, Table 3. The exposure, at 27.46 percent, although markedly lower than in the case of either Lebanon or Turkey, remains high enough that a default would have serious direct implications for the Brazilian banking system, even without allowing for the impact on

² Deputy General Manager, Lebanese bank, interviewed 3 September 2005. Also: ‘If the government goes bust all the banks, because we have...our money in there. We don't have any major income out of the country. So definitely we are in the same boat’ (Deputy General Manager, Lebanese bank, 2 September 2005), and ‘we see if the government goes down all the banks will go down’ (Assistant General Manager, Lebanese bank, interviewed 12 September 2005).

³ ‘[E]ven if I was very cautious, and I said...I don't want to make money, I will put all my money outside Lebanon....And suppose that the Lebanese government will default, it's a system...it's like Argentina, it's not me that “Oh I was smart I didn't place money”, but it's the same problem’ (Senior Manager, Lebanese bank, interviewed 7 September 2005).

⁴ As of 2 August 2006, foreign assets represent 88.7 percent of the Turkish central bank's assets (www.tcmb.gov.tr/yeni/eng/index.html, accessed 7 August 2006). The IMF's estimate of the Banque du Liban's net claims on the Lebanese government at year end 2005 was LP11,448 billion (US\$7.59 billion), with a net foreign exchange position of LP3,627 billion (US\$2.40 billion) (IMF 2006c: 33). The net claims on the government are equal to 26.3 percent of total assets (total assets from Banque du Liban, www.bdl.gov.lb/rates/weekly/BDL_interimBalanceSheet.xls, accessed 26 January 2007).

⁵ ‘[T]he sovereign risks is not for someone, it is for everyone. So if government fails, everyone will fail. So it is best to...invest in the sovereign’ (Manager, Turkish bank, interviewed 6 December 2005).

banks' balance sheets of the likely fall in overall economic activity. As will be discussed below, however, such an assumption is only true if the exposure is unhedged.

Summing up, the comparison for the three countries of the exposure of domestic commercial banks to their own government, although difficult to determine exactly, shows considerable variation, and is approximately as in Table 1. The figures suggest high exposure in all three countries, but with Brazilian banks having approximately half the exposure of the other two countries.

Table 1

Percentage of commercial bank assets invested in government bonds

	Percentage of total assets (most recent data)
Brazil	27
Lebanon	54
Turkey	51

The data in Table 1 suggest the importance of government bonds to the banks, but the question here is loyalty that varies with the ability of the banks to exit the market. The ability to exit is the ability to sell their government securities holdings. This is constrained by regulation, prompting 'submissive Loyalty' (Cohen 1998: 132), but also by the financialisation of the government debt market and of the banks themselves. Central to the question of the ability to sell is how high a percentage of the outstanding government bonds are owned by the banks in the countries studied. If an individual investor, or a small group of like-minded investors, own a high proportion of the market, they may be unable to sell their bonds, because there will not be alternative buyers available.

In the case of domestic securities, statistics for ownership of bonds are readily available. For Turkey, the figures for non bank resident investors and all non-resident investors,⁶ as of 26 October 2006, are set out in Appendix B, Table 4. According to these figures, of the outstanding domestic ‘market’⁷ debt of the Turkish government, 62.7 percent is owned outside the banking sector, 37.3 percent by banks. In Lebanon, at end-October 2006, ownership of domestic government securities was divided as in Appendix B, Table 5. Using the same measure as applied to Turkey, the banks own 79.4 percent of domestic government securities held outside the central bank.⁸ The most recent figures for Brazil relate to 29 September 2006,⁹ as in Appendix B, Table 6. Banks own 43.2 percent of the total outstanding domestic government bonds held by the public, with their proprietary holdings (i.e., those held voluntarily, rather than for regulatory requirements) 32.3 percent of the total. This is important when considering the relative importance of enforced loyalty. The Brazilian banks’ voluntary purchases of government bonds are almost three times the regulatory minimum.

Holding such percentages of a market creates, in itself, problems if the banks wish to exit, most obviously in Lebanon but also in the other two case study countries. This is particularly the case for the larger banks. Interviewees acknowledge these issues. In Turkey, the large banks cannot sell more than about US\$300 million equivalent in a day, leading one to conclude they could not sell their portfolio in a year.¹⁰ Similarly, the Lebanese banks, if they wanted to sell, are faced with a ‘one way’ market, with everyone

⁶ www.hazine.gov.tr/english/kaf/2006dibs_eng.xls, accessed 4 January 2007

⁷ Not held by the public sector, including the central bank, non-cash sales to public banks and the savings deposit insurance fund.

⁸ The comparison with Turkey is not exact, as the Lebanese ‘non-banking system’ includes government agencies such as the social security fund.

⁹ www.tesouro.fazenda.gov.br/english/hp/public_debt_report.asp, Table 7, accessed 7 January 2007.

¹⁰ ‘I can trade 300 million...dollar worth of local government securities but I can't trade a billion. I just don't have that liquidity. Neither in the underlying or in the derivatives.’ (Deputy General Manager, Turkish bank, interviewed 5 December 2005; the US\$300 million figure was also given as the amount that could be sold in a single day by Head of Treasury, Turkish bank, interviewed 7 December 2005), and ‘The local banks cannot sell off everything and go flat or go short the market’ (Treasurer, Turkish bank, interviewed 7 December 2005).

trying to sell, and so do not attempt to sell, for fear of pushing down prices.¹¹ One interviewee believed a US\$20 million trade in Lebanese Eurobonds would move the market 1-2 percent in price. In a period of great uncertainty, such as after the assassination of former Prime Minister Hariri (see below), US\$5 million would be sufficient. In the domestic bonds, LBP20 billion (US\$13.3 million) is a large trade.¹² In Brazil, however, the situation is different, with a relatively liquid market, except at the longest maturities. As will be discussed below, this is the result not only of the lower percentage of government bonds held by the banks, but also of the level of market financialisation.¹³

Looking at the foreign currency government bonds of the three countries, accurate figures are difficult to compile, but it is clear that the assumption that bonds issued 'offshore' are bought exclusively by international investors is incorrect. In all three countries, interviewees, both in the case study countries and outside, were asked the extent of domestic ownership of government bonds. In Turkey, in addition, international bonds issued by the government in 2004, 2005 and January 2006 (from data provided by the Turkish Treasury), denominated in both US dollars and euros, were examined. In thirteen separate issues, or individual borrowings, analysed, of the top five largest 'orders' (i.e., the investors stating a willingness to buy the largest volume of the bonds), on one occasion all five were Turkish, on two occasions four were Turkish, on eight occasions three were, and on two occasions two. Thirteen investors appear more than once amongst the five largest investors in an individual issue: only four are not Turkish

¹¹ 'On the...Lebanese pound denominated Treasury bills, there is very, very, very few secondary market deals' (Head of Treasury, Lebanese bank, interviewed 12 September 2005); 'Unfortunately when I want to sell Treasury papers because of a certain political issue, everybody is selling so there is no market ... This is the bad thing about Lebanon. It's a one way market in all aspects. If you are borrowing, everybody is borrowing. If you are lending, everybody is lending. If you are buying, everybody is buying' (Deputy General Manager, Lebanese bank, interviewed 2 September 2005); '[if] all the banks want to sell Lebanese Treasury bills, you cannot find a buyer' (Head of Treasury, Lebanese bank, interviewed 9 September 2005).

¹² Senior Manager, Lebanese bank, interviewed 7 September 2005.

¹³ A larger market, such as Brazil, might be expected to mean that it is easier to sell bonds. However, what is important for the banks is the size of their holdings relative to the overall market. If the banks hold 50 per cent of the market, for example, selling will be difficult, regardless of the market's overall size.

banks (and two of these are European banks that own banks in Turkey¹⁴). The twelve Turkish investors that appear amongst these top five orders are all banks.

Analysis of Turkish banks' balance sheets,¹⁵ show that, as of 22 December 2006, banks held a portfolio of Turkish international bonds of US\$12.5 billion, 34.4 per cent of Turkish government international bonds.¹⁶ Interviewee estimates are higher, generally at 45 – 50 per cent for interviewees in Turkey (including a Treasury official) and anywhere from 30 to over 80 per cent for international market actors.¹⁷ Either way, the figure is significant. For Lebanon, Appendix B, Table 1 shows banks' holding of international bonds,¹⁸ as of April 2006, totalled US\$10.2 billion, 77.2 per cent of outstanding 'Market Eurobonds'.¹⁹ This clearly represents a figure far in excess of a percentage of outstanding bonds which could easily be sold. The Lebanese banks cannot exit. In Brazil, no accurate figures exist as to the total domestic holdings of Brazilian international bonds, and the greater diversity of domestic financial market actors makes splitting out bank investors more difficult. Interviewees in London and New York estimated domestic ownership at between 25 and 40 per cent. Domestic interviewees gave figures similar to the international, but there was great uncertainty, even from an interviewee at the Ministry of Finance. In addition, the official, based on feedback when the Ministry has tried to buy back international bonds, thought many bonds were held by 'big companies [so not banks] that issue abroad. I think they use the Brazilian bonds to

¹⁴ The Turkish Treasury has a publicly-stated policy of restricting the volume of new issues of international bonds sold to Turkish banks (Treasury official, interviewed 30 November 2005). European banks owning Turkish subsidiaries would therefore have an incentive to channel their subsidiary's interest through the parent bank, creating the impression of European demand and justifying receiving a larger allocation of bonds. The official interviewed appeared well aware of the potential for such tactics.

¹⁵ Figures provided by Turkish Treasury official, e mail communication, 8 January 2007, based on Banking Regulation and Supervision Agency ('BRSA') figures.

¹⁶ Figures for total outstanding bonds, end November 2006, www.hazine.gov.tr/english/kaf/CG-ExtDebtStock2006.htm, accessed 4 January 2007.

¹⁷ It may be that at least part of the discrepancy is that a further YTL6,311 million (US\$4,394 million) of foreign currency government bonds are held by the banks in custody for other, almost exclusively Turkish, investors.

¹⁸ Claims on the Public Sector - Treasury Bills in Foreign Currencies.

¹⁹ *Public Debt Monitor*, Ministry of Finance, April 2006, p.11. Available at www.finance.gov.lb, accessed 31 January 2007.

hedge [their foreign exchange exposure]’.²⁰ Until recently, Brazilian domestic investors have also had the option to buy domestic US\$-linked securities,²¹ potentially further reducing domestic demand for international bonds. It seems reasonable to conclude, therefore, that Brazilian banks hold a far smaller proportion of their government’s foreign currency bonds than their counterparts in Lebanon and Turkey, and are therefore more able to sell their holdings should they choose. They have a greater option to ‘exit’.

Table 2

Commercial bank holding of government debt held outside the central bank

	Domestic Debt (Percent)	International Debt (Percent)
Brazil	43.2	25-40
Lebanon	79.4	77.2
Turkey	37.3	34.4

Table 2 summarises the percentages of commercial bank holdings of government debt. The sources are central banks, government Treasury departments or bank regulators (see Appendix B), except for the holding of international debt by Brazilian banks. This last figure should be treated with considerable caution. It is based solely on uncertain market estimates given in interviews. Given the diversity of financial market actors in Brazil, it is almost certainly too high. It seems likely that the Brazilian banks may well be able to sell any holdings of Brazilian international debt, to exit the market. In all the domestic debt and the Lebanese and Turkish banks holdings of international debt, however, it is clear that there would be substantial difficulties in exiting the market, if it was possible at all. When combined with the banks’ exposure to the economy of their country, the evidence suggests strongly that domestic commercial banks have limited (but across the

²⁰ Interviewed 6 September 2006.

²¹ Turkish US dollar domestic securities also exist, but in smaller volumes.

case study countries, varied) ability genuinely to ‘exit’ either a government debt market itself or their exposure to the consequences of a government debt default.

The inability to ‘exit’, induces greater ‘loyalty’ on the part of domestic commercial banks, with consequences for their behaviour as investors.

Different Definitions of Loyalty

If it is accepted that commercial banks have a reduced ability to exit by selling their bonds, they are more likely to demonstrate loyalty, as Hirschman defines it. The banks clearly demonstrate loyalty as a result of their ownership of a large proportion of their respective markets. The most obvious penalty for exit would be substantial price falls as the banks attempted to sell. Loyalty can therefore be seen as flowing directly from that cost of exit, even if the large amounts of government bonds held are not only enforced by regulation. However, Hirschman’s second conception of loyalty (see chapter 1) also applies. For the larger bank buyers of government bonds, a sale of a bond (or a decision not to buy a particular new bond issue), may lead to a fall in the price of other bonds the bank holds (‘material sufferings’) but also a deterioration in the government’s ability to finance itself, *in extremis* leading to default (a ‘further deterioration in the quality of the organization’s output’), and ‘the member cares about this deterioration’, because of the remaining holdings of bonds, or because of the bank’s overall business in the country, which would be harmed by a sovereign default. ‘In other words, *full exit is impossible*’ (Hirschman 1970: 100; italics in original). Such a situation faces a bank deciding on investment in its own government’s bonds, and increases loyalty: ‘If you want to do something drastic you have to keep in mind that it’s going to...have an impact on all the rest of your portfolio and assets’.²² This inability to exit fully includes a concern with the bank’s reputation (part of the value of its franchise), meaning ‘I can’t act like a hedge

²² Head of Treasury, Turkish bank, interviewed 7 December 2005.

fund'.²³ For another Turkish bank, concern with reputation meant they never went short, not because of concerns about being seen to be short *per se*, but because of not wanting to be associated with the fraudulent short selling revealed in the collapse of Imar Bank in 2003.²⁴

Commercial Banks as 'Quality-Makers'

Hirschman's second conception of loyalty relies on the banks in question seeing themselves as 'quality-makers' rather than 'quality-takers' (1970: 99). The bank purchasing bonds must not only care about the ability of the government to finance itself, but must believe that its actions have a material influence on that ability through the prices of the bonds in question. In the case of both Lebanon and Turkey, such a belief clearly exists. One Turkish bank had a strategy that did not involve aggressive trading of Turkish government debt, because such a strategy would have too great an impact on secondary market prices for other bonds the bank owned.²⁵ The interviewee also contrasted this strategy with that of a bank for which he used to work that is small enough to be able to trade their portfolio actively,²⁶ and recognised the degree to which

²³ 'I can't act like a hedge fund... I can't...[sell short when Turkey is hit by an earthquake], the hedge fund can do that, and he wouldn't care less if the news on the Turkish papers, saying that they have shorted the market after the earthquake...I can't do that, I'm a real bank, I got...close to 5 million credit cards. I'm working with nearly every corporate in Turkey, somehow, on either a credit or a transaction basis...[R]eputation means a lot to me. I have much more good will in my corporate valuation than [a leading international hedge fund]' (Deputy General Manager, Turkish bank, interviewed 5 December 2005).

²⁴ '[W]e don't [want] any allegation, even a micron close, a nano close to that issue. So we never went short' (Manager, Turkish bank, interviewed 6 December 2005).

²⁵ '[Y]ou cannot imagine a big bank unloading its securities portfolio into the market. That's not possible. I mean of course it's theoretically possible, but you couldn't do that... just assume [three large Turkish banks] are selling a certain issue into the market simultaneously, that's not possible' (Deputy General Manager, Turkish bank, interviewed 5 December 2005).

²⁶ '[T]hey could basically turn over all their portfolio in a week...I couldn't do it in a year. If you were to work for [such a bank] you would have a completely different strategy... you could have a bigger percentage of your portfolio in trading. And better traders than I have' (Deputy General Manager, Turkish bank, interviewed 5 December 2005).

it was necessary to consider the impact of the bank's trading on other market participants.²⁷

In Lebanon, where a small group of large banks dominate, the feeling of loyalty is even stronger: 'at least I have to keep...what I already have with the government...and if the government...needs some money, I have to give it'.²⁸ This is in part because of the banks' existing holdings of bonds, but also because they are exposed to the Lebanese economy as a whole.²⁹ Beck *et al.* (2003) show that a more concentrated banking system makes banking crises less likely³⁰ (see also Allen and Gale 2000). Although they also show that competition and fewer restrictions on bank activities have a positive impact, it may be that the likelihood of greater loyalty in more concentrated banking systems is also part of the explanation. This requires the banks to feel that they have the capacity to influence the pricing of government bonds. The following section will consider two important components of that capacity – the absolute size of the banks, and the way they account for their holdings of government bonds.

The size of banks

The size of the banks matters to loyalty in three ways. First, the size of the banks relative to the overall economy is a factor in how much private sector lending they can prudently

²⁷ '[E]ven if you put the regulatory thing inside, from a game theory perspective you know your gains are limited depending on how big you are. Because there is always second guessing by other players. So...you just can't individually maximise your bank's benefits by just thinking along your own terms. You have to take into account what other players... forget about the Treasury, what other players would do or how would they react if you were to sell everything into the market. Or basically even don't buy into the auction and redeem your portfolio. That's a small market, you're talking about 7, 8 players, everybody would understand what you are doing...You just cannot maximise your benefits by not taking what other people think about your strategy into account' (Deputy General Manager, Turkish bank, interviewed 5 December 2005).

²⁸ Executive Advisor to Chairman, Lebanese bank, interviewed 8 September 2005; also 'We are supportive of the government and the government understands that we support the government. It's a catch 22' (Deputy General Manager, Lebanese bank, interviewed 3 September 2005).

²⁹ Senior Manager, Lebanese bank, interviewed 7 September 2005, quoted footnote 3 above. Same interviewee: 'So [if] I was very cautious, I [wouldn't] make money. And when the system fall[s] down, I would fall down with them'.

³⁰ The study considers 79 countries, developed and emerging. Turkey is included in the data set, Brazil and Lebanon are not.

make, as an alternative to holding government securities. Second, the actual volume of bonds held as a result of reserve requirements for deposits taken are the result not only of regulation (both of absolute reserve requirements and of the proportion which can be held in government bills and bonds rather than cash), but also of the absolute volume of deposits the banks hold. Third, the capacity of the banks to influence the prices of government bonds, to be ‘quality-makers’, not ‘takers’, is obviously connected to their size relative to the government bond markets they may or may not influence. Table 3 suggests one way this might be measured.

Table 3

Bank Capacity Relative to Government Borrowing (End 2005 unless stated in footnote)

	Bank Assets to GDP (Percent)	Domestic Government Borrowing to GDP (Percent) ³¹	International Government Borrowing to GDP (Percent)	Bank Assets/Total Borrowing
Brazil	73.7 ³²	48.9 ³³	9.0 ³⁴	1.27
Lebanon	259	52.3	57.9 ³⁵	2.35
Turkey	89.5 ³⁶	34.8	29.5 ³⁷	1.39

Source: IMF, Banco Central do Brasil, Banque du Liban, Ministry of Finance, Lebanon, Central Bank of Turkey, Turkish Treasury³⁸

³¹ Excluding domestic government bonds held by the central bank for Brazil and Lebanon. For Turkey, this is the figure for domestic securities classified by the Treasury as ‘Market’, which excludes holdings by the central bank, ‘non-cash sales to the public banks and cash sales for the interest payments of the noncash securities issued to the public banks’.

³² Assets as at November 2006 compared to December 2006 GDP.

³³ ‘Federal securities in market’

³⁴ Not split between bond debt and other debt

³⁵ This figure excludes bonds issued to certain lenders (including the UAE, Kuwait, Oman, Qatar and Saudi Arabia) as a result of the Paris II conference, which is bilateral lending, and zero interest bonds issued to the Lebanese banks as a result of their contribution to Paris II (see below).

³⁶ End June 2006

³⁷ End October 2006

³⁸ www.imf.org, www.bcb.gov.br, www.finance.gov.lb, www.bdl.gov.lb, www.hazine.gov.tr, www.tcmb.gov.tr

This is a crude measure, but indicative nevertheless. While the Lebanese government's borrowing requirement is enormous when measured by the conventional debt to GDP, it is less strikingly large when measured by the capacity of the domestic financial system (and loyal institutions within that system) to buy government debt (see Barakat 2003: 163). Brazilian and Turkish banks have a similar, far lower, capacity, with the larger assets to GDP of the Turkish banks more than offsetting their government's higher debt. These figures suggest not only the extent to which banks might see themselves as 'quality-makers', but also the level of government borrowing relative to the capacity of one group of relatively loyal investors to buy that debt.

Accounting (or Performance Measurement)

Capacity is obviously far more than simply relative size. One other important influence on bank behaviour, and a marked contrast with most other investors, is the way they account for their holdings of government securities, or how performance is measured. Like all investors, banks are assumed to be profit-maximising in their decision making. However, how that profit is measured is dictated by accounting practices, and influences investment decisions.

Banks in all three countries follow International Accounting Standard 39 (for a summary of IAS 39, see Deloitte Touche Tohmatsu 2006). This complicated standard is another example of the internationalisation of standards and regulation (see below). IAS 39 gives bank investors in government securities a choice of three ways to account for government bond holdings, each of which leads to a different way in which profit is calculated. The choice effectively is to place the securities in one of three different 'books'. The first choice is to place the bonds in the trading book. Bonds in the trading book can be sold at any time, and the profit or loss of the bond holdings is calculated on a 'mark-to-market' basis (i.e. the price of the individual security is set at the then-

prevailing market price) whenever profit and loss is reported. Any profit or loss on the bonds appears in the statement of profit the bank reports, usually every three or six months. The second option is the place bonds in the 'available for sale' book. Such bonds are treated the same way as bonds in the trading book, except that any profit or loss incurred does not appear in the profit statement, but is instead added or subtracted from the overall equity of the bank, which is generally not the focus of equity analysts.³⁹ The third option is the most significant in its potential implications for investment. This is the option to place bonds in the 'investment' book. Bonds placed in the investment book are not marked to market: instead, profit is recognised on an accruals basis.⁴⁰ This means that a bond bought with a yield of 10 percent per annum will show an income of 10 percent for each year until the bond matures (is repaid), regardless of any movements in the market price of that bond (and assuming, of course, that the borrower in question does not default). As a result, a bank purchasing bonds for its investment book can be confident of the income it will receive from that bond, even if market conditions change. A sharp fall in bond prices will not result in a loss in the profit statements of the bank; similarly, a dramatic rise in prices will not lead to an unsustainable increase in profits, potentially increasing shareholders' expectations unreasonably and resulting in an unwelcome tax bill.^{41 42}

Against this accounting advantage for the banks, however, must be set significant restrictions on the freedom of action regarding bonds in the investment account. While bonds can be moved from the trading or available for sale books into the investment book, they cannot be moved the other way (except usually for five percent of the total

³⁹ Deputy General Manager, Turkish bank, interviewed 5 December 2005.

⁴⁰ Allen and Gale (2000: 271) note the advantage for banks in a volatile environment of eliminating market risk.

⁴¹ 'I prefer not to have the market to market because otherwise...I will have huge profits... I don't want to book profits' (Senior Manager, Lebanese bank, interviewed 7 September 2005). Other banks felt they would generally increase the proportion of their bond holdings that were available for sale when they were optimistic about the market.

⁴² Prior to the adoption of IAS 39, any government bonds which were purchased as part of the initial new issue borrowing process would be considered as 'originated loans'. Such a designation combined the attraction of not marking the bonds to market with the ability to sell the bonds at any time without negatively changing the accounting treatment of the whole portfolio. The government bonds held were accounted for on an accruals basis, but could be sold at any time.

investment book holding in any year) without the entire investment book having to be moved.⁴³ As a result, if the market is weak, prompting a bank to wish to sell some of its investment portfolio, to do so requires that the entire portfolio be revalued at the new, lower prices. The resultant losses could represent a significant impact on the profit of the individual banks. Interviewees indicated this was not an option they would utilise, except under the most extreme situation.

The ability to put bonds in the investment book, and, crucially, not to have a mark-to-market those positions, has a material influence on the decisions of banks in buying and selling government securities. 'It's a small accounting thing but it changes everything in the way of running business and it changes incentives to buy and sell at specific times'.⁴⁴ The first way in which decisions are influenced is that bank investors, within their investment portfolio, are long term 'buy and hold' investors: 'my 30 year bonds will never come back within the next 30 years'.⁴⁵ The international investors interviewed are generally taking views for a maximum of three to six months, with some even more short term (see chapter 5).⁴⁶ In contrast, a bond bought into the investment book is almost certain to be held to maturity. In the case of Lebanon, this could be up to fifteen years, in Turkey 30 years and in Brazil 40 years (although the bond in question can be repaid, or 'called', after 15 years). The decision to sell is influenced by Hirschman's second conception of loyalty: the concern is for the consequences for the remainder of the portfolio. Such an investment is therefore not undertaken lightly, given the opportunity costs involved, and in some banks involves a board decree.⁴⁷ In its

⁴³ The exact interpretation appears to depend on individual auditors, because the sale from the investment account must not have a material impact on the profit and loss of the bank (Assistant General Manager, 50 per cent foreign-owned Turkish bank, interviewed 8 December 2005).

⁴⁴ Investment bank trader, London, interviewed 5 January 2005.

⁴⁵ Assistant General Manager, 50 per cent foreign-owned Turkish bank, interviewed 8 December 2005; also 'in the investment book, the guy is putting in his book and basically he's not going to look at it again' (investment bank research analyst, London, interviewed 23 June 2005).

⁴⁶ Observing of one bond, 'this position that I've kept is three weeks old...that's a long time...Nobody buys and keeps things for six months, a year, I mean things change' (Hedge fund manager, London, interviewed 23 June 2005).

⁴⁷ '[Y]ou should be...using it sparingly because business is an ongoing concern...maybe a one time opportunity for that year, but how about next year, the year after that. Maybe we are going to have better opportunities' (Deputy General Manager, Turkish bank, interviewed 5 December 2005).

regulation of banking (see further discussion below), the Basle Committee on Banking Supervision (1997a: 36) recognises the importance of the accounting distinctions: ‘unlike the banking [or investment] book, the composition of the trading portfolio changes significantly from week to week or even day to day because it is managed separately and according to a different (shorter) risk horizon than the banking book’.⁴⁸

As well as being more long term, the banks’ investment books also give them different ways to respond to market weakness compared to other investors. First, existing holdings can be moved from the trading or available-for-sale books to the investment book, to avoid the reporting of losses, or potential future losses that may be anticipated. As one trader who had worked in both domestic Turkish and international banks observed, ‘the losing position[s] generally find their way in[to] investment portfolios’,⁴⁹ although, perhaps not surprisingly, domestic interviewees did not suggest this was happening. In addition to allowing banks not to recognise losses on existing positions, the removal of concerns regarding future price falls also allows bond purchases at times of severe market weakness. Banks in both Lebanon and Turkey (although not all banks) acknowledged buying bonds in periods of serious market stress, such as after the assassination of former Prime Minister Hariri in Lebanon in February 2005 or during Turkey’s financial crisis of 2001, because they were able to put the bonds in the investment account and not mark to market if prices fell further. For one large bank, all the bonds in the investment account, at the time of interview 14 per cent of the portfolio, had been purchased at a time of severe market weakness.⁵⁰ This accounting treatment has increased the ability of banks to be ‘quality-makers’, and to be loyal.

The extent to which banks use the investment book varies markedly. One Turkish bank, 50 percent foreign-owned, had over 90 per cent of all bonds in its investment book.⁵¹ In

⁴⁸ The term ‘banking book’ is referring here to a bank’s overall lending business, of which holding government securities is only a part.

⁴⁹ Emerging market bond trader, London, interviewed 22 June 2005.

⁵⁰ Deputy General Manager, Turkish bank, interviewed 5 December 2005.

⁵¹ Assistant General Manager, interviewed 8 December 2005.

contrast, one Lebanese bank that had a strategy of being active in market making in government securities kept all its Lebanese pound holdings as available for sale, and generally 80-90 per cent of US dollar and euro holdings as available for sale.⁵² A foreign bank in Brazil did not use the investment book at all.⁵³ Interviewees indicated percentages for their banks which covered the whole range between these extremes. Some interviewees in all three countries studied considered the keeping of a higher percentage of bonds as available for sale or trading represented a more sophisticated approach to accounting for bond positions. The implication of the views expressed was that as banks became more sophisticated, they should be more involved in trading and selling bonds to clients, as part of an expansion of non-interest income, and thus have more of their bonds available for sale or in the trading book, and a greater recognition of the mark-to-market value of their bond portfolios. It would not necessarily be correct, however, to see this as necessarily a result of the direct internationalisation of banks becoming foreign-owned, as the highest percentage held in an investment account was by the 50 per cent foreign-owned Turkish bank cited above. Consolidated figures across the banking systems of Brazil and Turkey regarding the accounting treatment of securities portfolios show differences between the different types of banks. The figures for the largest banks in Brazil are set out in Appendix B, Table 7, and figures for Turkish banks in Table 8.⁵⁴ No such data are published for Lebanon, and interview data are inconclusive.

Differences in performance measurement can also be seen in how traders are rewarded. A trader at a Lebanese bank⁵⁵ makes decisions to buy or sell a small part of the bank's portfolio, but is rewarded based on the profitability of the whole portfolio, which is far too large to sell. A Brazilian bank trader, however, is, as his international counterparts

⁵² Senior Trader, interviewed 9 September 2005.

⁵³ Head of Sales and Trading, interviewed 30 August 2006.

⁵⁴ There are notable differences between the figures for Brazil and Turkey. Most obviously, Turkish-owned private banks hold only 13.7 percent of their securities holdings in the trading book, Brazilian-owned private banks hold 60.2 percent. This would suggest a more trading-oriented approach among Brazilian private banks, a possibility which is supported by the comparisons made in interviews of international traders (see below).

⁵⁵ Interviewed 12 September 2005.

would be, rewarded based on the profitability of his own trading, not the overall bank, despite being a partner of the bank. His trading decisions are taken accordingly: ‘If I...think that...to make money I...have to go short, I would go short, and...in my mind still my first job is...a prop[rietary] trader rather than a bank partner’.⁵⁶ At a Turkish bank with a proprietary trading desk, the amounts the traders are allowed to trade (limits) are kept low, because they might work against the interests of the larger bank portfolio of government bonds.⁵⁷

A longer term view of much of the investment, combined more generally with the nature of the commercial banking business, leads also to a different overall attitude to investment, when compared to other investors. Just as in their lending business, banks investing in government bonds are generally looking at the return relative to the interest rates they pay on deposits, as well as relative to other lending or investment opportunities they have. This is another area of difference from international investors, who will be looking at any investment in an emerging market government’s debt largely relative to the debt of other governments, and at their expected return on the basis both of interest income and of projected capital appreciation. However, once banks introduce proprietary trading operations, rather than their more traditional treasury functions, a focus on capital gains, on a par with other financial actors, becomes more likely. As far as the Turkish banks are concerned, the treasury function still dominates; ‘they look at the relative spreads of the asset [to] liabilities, even though...the cost of liabilities can increase, they tend to like...positive spreads and sit on positive spread trades’.⁵⁸ The situation in Lebanon is similar. Trading appears relatively more important for the Brazilian banks.

⁵⁶ ‘I work at a prop[rietary trading] group, in some sense I am partner of the bank but I am relatively selfish in the sense that I take home a percentage of the money that I make here on my P and L. At the end of the day I’m a partner but if I was not a partner I wouldn’t give a shit about the bank’s result...and that’s the mentality of other traders. If I would think that in order to make money I would have to go short, I would go short, and...in my mind still my first job is still as a prop trader rather than a bank partner and that’s how it works. So my compensation has little to do with the bank result’ (proprietary trader, Brazilian bank, interviewed 29 August 2006).

⁵⁷ Deputy General Manager, Turkish bank, interviewed 5 December 2005.

⁵⁸ Emerging market bond trader, London, interviewed 22 June 2005.

Examples of Commercial Bank Loyalty

This section examines three examples of how loyalty has manifested itself in somewhat unexpected ways, two from Lebanon and one from Turkey.

Lebanese Banks' purchase of zero interest government bonds

The first is the response of the Lebanese banks to the 'Paris II' conference which took place in November 2002. At this meeting, the Lebanese government asked for, and received, international support totalling US\$4.3 billion in the form mostly of bilateral loans. The banks in Lebanon subsequently agreed to 'purchase zero-interest, two-year government securities in an amount equal to 10 percent of their deposit base as of October 31, 2002 (US\$3.8 billion, after some exemptions)' (IMF 2003a). This was 'burden sharing with the banking system' (*ibid.*). In other words, the banks agreed to lend the Lebanese government US\$3.8 billion for nothing, at a time when the government's debt to GDP ratio exceeded 165 percent.⁵⁹ Why?

Interviewees' answers reveal various different motivations connected to loyalty. For one, the loyalty being demonstrated is in part the result of his concern with his reputation with other banks. He also demonstrated the loyalty that comes from caring about the government's ability to finance itself, even if he does exit. This results from both the fact that 'full exit is impossible' (Hirschman 1970: 100), and from a belief that his exit will have a material impact on the ability of the government to finance itself (*ibid.*: 99).⁶⁰ In another banker's perception, the loyalty is enforced by the ability of the

⁵⁹ IMF (2006c: 54).

⁶⁰ 'They said listen guys, ...foreign governments helped Lebanon in 3.4 billion dollars. So as a bank, making...huge money out of the government, we think ... you should pay... So we gave...10% of our deposits...You cannot say no.... saying no would cost you much much more than paying this money...not in money terms...This is a cause for the government, this is a cause that should bail [out] the government and the financing of the country. As a bank you cannot say no...It would be looked upon very badly....One of the banks, not in this thing, sometime else, he said I don't want to roll over my deposit for

authorities to regulate (or enforce loyalty).⁶¹ For another, while the regulatory threat is clearly there, so is a less enforced loyalty.⁶² The authorities could use regulation to enforce compliance if necessary, but the banks' loyalty made this unnecessary (although there was obviously a Banque du Liban circular issued).⁶³

Lebanese banks' actions after Hariri's assassination

The second example also concerns Lebanon, immediately after the assassination of Rafik Hariri, the former Prime Minister and opponent of Syria, in February 2005. At a time of enormous political uncertainty, local bank depositors switched US\$5.5 billion⁶⁴ of their deposits from Lebanese pounds to US dollars, causing the Lebanese pound resident deposits to decline by 33.2 per cent by the end of March. Simultaneously, total non-resident deposits fell by 11.8 per cent⁶⁵ as US\$2 billion left the country.⁶⁶ This activity threatened the main anchor of the Lebanese government's economic policy, the effective fixing of the currency to the US dollar, which has been in place since 1993. A fall in the currency threatened economic crisis being added to the political crisis.

The banks reacted in three important ways which assisted the central bank's management of the crisis, rather than the exit strategy which would be expected, at least

the government. There was a certain maturity, a bond maturity and it was a big deal, a big amount, and he decided I will not... this was one of the largest banks in Lebanon, and within 24 hours all the banks in the country knew that Mr so and so doesn't want to...rebuy his bond, and the situation was really very bad for the government on a finance level...and he was looked up[on] very badly... [by] the banking sector...I think everybody was convinced this is our country, this is our economy, this is our financial position' (Deputy General Manager, Lebanese bank, interviewed 2 September 2005).

⁶¹ 'They told us...we would like you to contribute...and this is your contribution. And we told them that we are not interested in such contribution, and they said you better do it...We could not say no...It was as simple as that. They could have asked us that under the code of money credit, they can impose reserve requirements on either side of the balance sheet, and any currency they could have imposed it' (Deputy General Manager, Lebanese bank, interviewed 3 September 2005).

⁶² '[T]hey were thinking...we have to help the system if we want to survive...we made a lot of money also before so we can sacrifice a bit now... But then nobody could really say no,...the circular just came out and the banks had to abide by it' (Assistant General Manager, Lebanese bank, interviewed 12 September 2005).

⁶³ A similar request was made to the banks in 2007 (IMF 2006c: 16; *Daily Star*, 20 March 2007).

⁶⁴ IMF (2006c: 6).

⁶⁵ www.bdl.gov.lb/pub/qb/qb104/index.htm, p.9, accessed 5 January 2007.

⁶⁶ IMF (2006c: 6).

of international investors. There was ‘tight [Banque du Liban] – banks cooperation’ (Bank Audi Research Department 2005a: 2). Prudential regulation prevents Lebanese banks from running any significant currency mismatch on their balance sheets. Therefore, they sold Lebanese pound securities to the Banque du Liban, and exchanged the pounds received for US dollars, again with the central bank, the only buyer of the Lebanese currency as it supported its value. Such action depletes the central bank’s foreign currency reserves. The risk-averse strategy at a time of such uncertainty would have been for the banks to place the US dollars outside the country, most likely with highly-rated international banks. This option was available in a country without capital controls. However, the US dollars were placed on deposit with the Banque du Liban. As one banker observed, ‘if we had really done what theoretically...a risk averse person would have done, definitely [the currency] would have collapsed’.⁶⁷ Effectively, as the central bank lost foreign currency reserves as it intervened to support the currency, it regained them as banks deposited their US dollars there. Gross reserves fell, but were maintained at close to US\$8 billion (IMF 2006c: 7). Meanwhile, the central bank’s ‘net foreign exchange liquidity’⁶⁸ fell close to zero. The banks also accepted swaps to lengthen the maturities of government and central bank debt (IMF 2006c: 6⁶⁹), when in similar situations (for example, Brazil in 2002) investors would be expected to reduce the maturities of their exposure, despite inducements.

Second, the banks acted to encourage their depositors to remain calm, and not to switch their deposits. Note that the deposits being switched were largely staying with the banks, so this was not generally trying to persuade against withdrawal, although it should be

⁶⁷ Senior official, Lebanese bank, interviewed 8 September 2005. Also (same interviewee): ‘[Y]ou bought dollars as banks, but you have to place them...with the Central Bank.... so you cannot take them out...it’s not they enforce them, but they....encourage...really strongly by persuasion and everything, otherwise they would have collapse[d]... and it worked’.

⁶⁸ Defined as ‘Gross international reserves minus principal and interest due over the next 12 months on all foreign currency liabilities of the central bank to entities other than the government of Lebanon. Excludes long-term foreign exchange liabilities of the central bank’.

⁶⁹ The issuance of high yielding 10 year certificates of deposit by the Banque du Liban, also mentioned by the IMF, replenished reserves, but came slightly after the initial crisis.

recognised that the banks generally make a higher spread on their business in Lebanese pounds,⁷⁰ and that US\$2 billion was withdrawn. Branch managers at one large bank were told how to calm their anxious depositors.⁷¹ Standard & Poor's (2006) confirms: 'Banks' managements were responsible for briefing branch managers so they could help avoid customer panic, which would have led to uncontrolled demand for dollars against Lebanese pounds. This proved successful'.

The third important action by the banks relates to a decision, regarding general practice by the banks in the market, taken prior to the assassination. This relates to the lending of bonds. The Lebanese banks have a 'tacit agreement' not to lend government securities,⁷² despite this being, on its own, a profitable activity. Effectively, this decision limits the further financialisation of the government securities market, by preventing the expression of disloyalty. Without the holders of any security being willing to lend the security, it is impossible to 'short', to sell a security one does not own, in the expectation of being able to buy the security later at a lower price. The stated motivation for preventing this disloyalty is a further example of loyalty: 'I believe...in free markets but you want to also act as a central banker...your business dictates that you want to make profit but not necessarily short term profit or fees, profit in the long term'.⁷³ Furthermore, the small size of the market means that the banker feels he can reasonably expect to discourage others from assisting a short-seller.⁷⁴ He can expect to be, by his actions, a 'quality-maker'.

⁷⁰ Senior Manager, Lebanese bank, interviewed 7 September 2005.

⁷¹ '[W]hat to say...to relax a little bit the customer...Hariri died, you had angry customers, they want to...break [their deposits before maturity]...But we had the branch manager sit with each one of them, half an hour or one hour and talk to them,... talk them out of...just be patient, it's just a phase' (Head of Treasury, Lebanese bank, interviewed 9 September 2005).

⁷² Senior official, Lebanese bank, interviewed 8 September 2005.

⁷³ Head of Treasury, Lebanese bank, interviewed 9 September 2005.

⁷⁴ 'When I get calls from [an American bank], looking for a trade to short Lebanese pounds I will do everything I can, not only not to facilitate it but to make sure he doesn't do it with anybody else as well. I'm not in it for short term profit, I'm in it for going with the grain'.

The Lebanese banks are interested in long-term profitability, believing ‘it wasn’t very interesting for us to create some more volatility on this market’.⁷⁵ In Turkey, banks do, as part of their normal business activity, lend government securities, but some reacted to the extreme market uncertainty of 2001 by ceasing to lend,⁷⁶ thereby making shorting, and its further downward pressure on prices, much more difficult. An important part of this decision, for the large banks in both countries, is that, for them, there is little to be gained from facilitating this financialisation, since they are effectively unable to exploit it. Lebanese banks are not permitted by the central bank to short, but even if they were allowed, to short securities in sizes large enough to have an impact on their own profit and loss accounts, they would have to borrow bonds from the other large banks. The situation is the same in Turkey. The other banks would, as a result, know a bank was shorting bonds, and could exploit the situation, for example by ‘squeezing’ the price of the shorted security higher, resulting in losses for the bank which had originally taken the short position.⁷⁷ Interviewees in both Lebanon and Turkey were confident that the activities of the big banks are well known in their market.⁷⁸

This attitude not only limits overall trading activity (because, for example, trading that involves being long one security against short another becomes much more difficult), it also makes the development of a credit derivatives market more difficult. Credit derivatives (most commonly, credit default swaps, or ‘CDS’) are ‘financial contracts that allow the transfer of credit risk from one market participant to another, potentially facilitating greater efficiency in the pricing and distribution of credit risk among financial market participants’ (Bomfim 2005: 4. See also for detail on credit derivatives). Effectively, a buyer of a CDS is buying insurance against default, but it is insurance that can be traded. CDS are a means to greater financialisation, including the

⁷⁵ Head of Treasury, Lebanese bank, interviewed 12 September 2005.

⁷⁶ Assistant General Manager, Turkish bank, interviewed 8 December 2005; also Deputy General Manager, Turkish bank, interviewed 5 December 2005.

⁷⁷ Assistant General Manager, Turkish bank, interviewed 8 December 2005.

⁷⁸ For example, ‘[W]henver two or three banks, the major players in the markets, wants to buy or sell, the others... you see the others align with the interest of these banks’ (trader, Lebanese bank, interviewed 12 September 2005).

ability to have greater leverage in trading activity. The credit derivatives market, when fully functioning, also allows market participants to take credit risk on a borrower, a government or otherwise, in the expectation either of a credit improvement or deterioration. The risk can be taken in the precise form the participant wishes, regardless of the underlying bonds the borrower has issued. So, for example, an investor would be able to make an investment for two years, despite the fact that the borrower in question has not issued bonds with a maturity shorter than 5 years. This is, however, a derivatives market, a derivative of the underlying credit market, meaning its development requires a liquid underlying market. It is impossible for the market to develop without market participants willing to take short positions, trading in the expectation of credit deterioration.⁷⁹ This does not require the ability to take short positions in the underlying government bonds (both sides of the trading can take place in the CDS market, for example), but the development of the market is curtailed. This is the case in Lebanon, where it is the attitude of the domestic banks to allowing shorting activity that limits CDS activity.⁸⁰ In the specific case of the day after the assassination of Hariri, despite the great uncertainty, one international trader (interviewed 18 February 2005, 4 days after the assassination) had seen only one CDS trade taking place in the market. The (notionally) international bond market virtually closed down, because a holiday was declared in Lebanon.

Overall, in a crisis situation, as prevailed in Lebanon after Hariri's assassination, the fact that the government debt market (and indeed the financial system in general) is less financialised served to prevent the strongly negative market reaction that would have made the management of the potential crisis so much more difficult. The Lebanese market is dominated by a small number of large commercial banks, who feel loyalty to

⁷⁹ The ability to short bonds is important for hedging purposes. If an intermediary sells a CDS to a client, the intermediary would lose money if the credit underlying the CDS deteriorates. This is generally best hedged, in the absence of a liquid CDS market, by shorting the bonds of the underlying credit (see next footnote).

⁸⁰ '[I]f somebody lifts you out of protection [i.e., buys protection against Lebanon defaulting]... then you're short protection in Lebanon...so you're really screwed,...you have to go...find something else to do...the other side [i.e., to do a trade which nets out the position]' (emerging market debt trader, London, interviewed 17 February 2005).

the government bond market. Despite substantially increased dollarisation of deposits and US\$2 billion of capital flight, the exposure of the banks to the government (including Banque du Liban) *increased* in the first quarter of 2005 (Bank Audi Research Department 2005b: 9). As a result of the loyalty of the banks, and their ability to limit the financialisation of the government bond market, the spreads of international government bonds *fell* over the same period (Bank Audi Research Department 2005a: 10), and the government was able to continue financing (Bank Audi Research Department 2005b: 11). Mosley (2003: 154) notes Lebanon's ability to issue also during the Russian crisis of 1998, the result of 'an extreme version of resident investors' regulatory incentives' (*ibid.*: 240). However, as will be argued throughout this study, regulation represents only a part of the explanation for the ability of investors to trade risk (their level of financialisation). The attitude of Lebanese banks represents an important contrast with the situation in Brazil. Carvalho and Garcia (2006) show how, in what they term a 'sophisticated' financial market such as Brazil in the 1990s, controls on capital inflows were ineffective, because market actors were able to use complex structures to circumvent them. Their work shows the extent of financialisation in Brazil, but it also illustrates the attitude of the market actors.⁸¹ It seems unlikely that Lebanese banks, keen 'to also act as a central banker', would see it as in their interests to circumvent domestic regulation in the same way as occurred in Brazil.

Turkish Banks during the 2001 Crisis

In the third, Turkish, example, interviewees did not agree whether the banks concerned had the capacity, in a more financialised and internationalised system, to influence positively a crisis situation. It is nevertheless significant that they made the attempt (although the regulators in many countries might see what occurred as collusive market manipulation). The example occurred during the 2001 financial crisis in Turkey, when political uncertainty after a dispute between President and Prime Minister, and various

⁸¹ Carvalho and Garcia do not say that the individuals interviewed worked for domestic institutions, but the structures they discuss would clearly require domestic actors.

problems in the banking system,⁸² led to the collapse of a large number of banks. This necessitated direct state intervention, and resulted in severe weakness in the currency and bond markets in Turkey (Ertürk 2003; Akyüz and Boratav 2005; Altunışık and Tür 2005). As discussed above, a number of banks decided to cease lending bonds, so making it harder for others to bet on further falls in the market. Six banks also, however, decided to intervene more directly in the foreign exchange market, forming what was effectively a fund to support the Turkish lira by buying the currency in the market. Such intervention was similar to the actions of a central bank in supporting the currency.⁸³ The motivations of the banks involved fit very closely with the concept of loyalty, and in particular with loyalty engendered by an inability to fully exit, in contrast to their perceptions of the foreign investors: ‘because we do have [a] branch network and we have lots of customers, meaning if Turkey gets hit more, we as banks also get hit more...whereas for the foreign banks present in Turkey it’s just a trading game’.⁸⁴ This cooperation between the six banks was not the result of the government using any pressure, regulatory or otherwise, to organise this support: ‘although the government behind the doors perhaps supported that event,...they didn’t officially or they didn’t...encourage anyone to do such a thing’.⁸⁵ Interviewees were divided as to the success of this support operation, and the organisation of the cooperation appears to have been difficult, but the important point is that the banks saw it as in their interests to support the market in the face of foreign selling. Regardless of the success of the operation, it would appear reasonable to assume these banks were not simultaneously

⁸² In the state banks, brought about mainly by ‘duty lending’, lending directed for political rather than economic reasons.

⁸³ ‘Because of the foreigners just playing around...one local bank, he didn’t have that much power. Six of us got together, formed a good bucket of money and every day, one bank controlled that money, selling those dollars. If some foreigners started buying, one bank is selling...200 million dollars, today it’s nothing but 200 million dollars is good money during the crisis days. So that’s the kind of unity we had, locals against foreigners. Because foreigners were talking about the devaluation, collapse and everything’ (Head of Trading, foreign bank, Turkey, interviewed 5 December 2005. In 2001 the interviewee worked for a Turkish bank). Also Head of Research, foreign-owned Turkish bank, interviewed 8 December 2005. The bank in question was not foreign owned in 2001, and was one of the six banks; head of Treasury, Turkish bank, interviewed 7 December 2005; Assistant General Manager, Turkish bank, interviewed 8 December 2005.

⁸⁴ Assistant General Manager, Turkish bank, interviewed 8 December 2005.

⁸⁵ Treasurer, Turkish bank, interviewed 7 December 2005.

seeking to profit from the market weakness. A Turkish banker sums up the attitude: ‘if you are in a small community, in certain cases...we get together and say okay this is not for the bank, this is for Turkey’.⁸⁶

Explaining the Banks’ Behaviour

All three of these examples show how domestic banks can be seen as demonstrating loyalty to their own market, driven substantially by their inability to exit fully from their exposure to the government. This inability to exit is, in part, the result of regulatory constraints that keep assets at home. The constraints on Lebanese banks are especially tight, despite the free capital account, with the result that the banks consider themselves to have little option but to invest in government securities or make deposits at the Banque du Liban, particularly in Lebanese pounds. However, an explanation based solely on the government’s ability to regulate is inadequate. To fully understand the actions of domestic banks, it is necessary to recognise two important influences on their actions. First, they are subject to home bias in their investment decisions in the same way as other investors. Much of the explanation for home bias has been linked to the cost and difficulty of information gathering across borders (see chapter 1). For domestic banks considering investment outside their own country, the information asymmetry is particularly acute, since their central position in their own economy gives such expertise regarding that country. Interviewees in all three countries considered themselves better informed about their country than foreign investors. Domestic interviewees themselves attributed this more to their geographic location, but interviewees amongst international financial actors, while generally more sceptical concerning the advantages of domestic investors, recognised the fact that domestic investors spent more time analysing their own countries, giving them an advantage. This is in line with work on the influence of information asymmetries on financial contagion (see, for example, Calvo 1999; Calvo and Mendoza 2000a and 2000b), which focuses on the implications of low incentives to

⁸⁶ Assistant General Manager, 50 per cent foreign-owned bank, Turkey, interviewed 8 December 2005. The bank was not part foreign-owned in 2001.

pay the cost of information gathering in a diversified portfolio (such as that of an international emerging market bond fund). It is not simply the regulatory constraints preventing banks from diversifying across borders, it is this difficulty in acquiring the necessary information.⁸⁷ A large Brazilian bank, which does invest substantial amounts outside the country, recognises the effort involved.⁸⁸ It is not only the cost of acquiring the necessary information, but also other transaction costs⁸⁹ (Sobel 1994: 18; Davis and Steil 2001: 77).

The decision to acquire the information is also generally determined by the size of the bank, because the smaller the bank, the lower the absolute amount that can be invested abroad, while information costs are largely fixed. Banks in emerging market countries are relatively small (with the exception of four Chinese banks, none appear in the top 50 in the world by assets⁹⁰), and the three case study countries show considerable variation. The largest Brazilian bank at September 2006 had assets totalling US\$124.5 billion, and the top 10 average assets of US\$57.5 billion.⁹¹ This average exceeds the assets of Turkey's largest bank, at US\$48.5 billion, with the top 10 average assets US\$25.1 billion.⁹² Lebanese banks are even smaller, with the largest having assets of US\$10.8 billion, and the top 10 averaging US\$5.4 billion.⁹³ Lebanese banks will have a lower incentive to bear the costs of investing abroad. In the case of one Lebanese bank,

⁸⁷ 'I'm a little bit connected, I know people, but still I'm living in Istanbul. How much can you follow what's going on in London and New York, even if you have close friends working there and you talk to them regularly? But still you would miss some of the information' (Deputy General Manager, Turkish bank, interviewed 5 December 2005).

⁸⁸ '[W]e invest a lot in terms of trips, tonight we have a guy traveling to Argentina, I'm going next week to Singapore, the IMF meetings, we're in Turkey, Russia, Mexico, we travel a lot. These require some capital of course, but I think there is a lot of information available there for the one who wants to do homework' (proprietary trader, interviewed 29 August 2006).

⁸⁹ '[I]f your...total amount of funds is not so big, it's too costly, cost of the foreign investment is very high. So... you pay some foreign expertise, some custodian and some [safe]keeping...so it's difficult to have some investing in foreign [funds]. Usually you pay additional cost for the portfolio management issue' (Turkish Treasury official, interviewed 30 November 2005).

⁹⁰ www.bankersalmanac.com, accessed 17 January 2007.

⁹¹ www.bcb.gov.br/fis/top50/ingl/Top5020060901.asp, accessed 11 January 2007.

⁹² As of 31 December 2005. www.tbb.org.tr/english/book2005/tables/table%201.xls, accessed 11 January 2007.

⁹³ Baz 2005: 444. The earlier dates of the data for the Turkish and Lebanese banks distort the comparison slightly, but not materially.

regulation allowed investment of well over US\$100 million in BBB-rated foreign securities (based on the bank's equity [Baz 2005: 454]). The total investment at the time of the interview was US\$4 million.⁹⁴

A significant part of the incentive to diversify is assumed to be the reduction of overall risk, but a further disincentive for investing outside the country also appears to be that there is no increase in return relative to domestic operations. This is noted in the case of the investment by Lebanese banks in BBB securities.⁹⁵ This has an influence on other domestic investors also, as will be explored in subsequent chapters. In a country with high-yielding government bonds, diversification across borders either reduces returns (because investment is in lower yielding, better credit assets) or involves investing in another emerging market country, about which the domestic bank will know far less than about its own country. The credit rating of the cross-border investment may be similar or higher, but the domestic bank is far less likely to feel as confident as when investing at home. 'I think nobody except a local could understand the local dynamics of an emerging market....In my opinion I should reside in Rio for about 5 years to get the feeling of Brazil...then I might become an investor in Brazil'.⁹⁶ The advantage of cross-border investment is further reduced for emerging market banks by their need to offer higher interest rates on foreign currency deposits than their developed world counterparts. Lebanese banks, for example, deposit US dollars with international banks for risk management reasons, but make a loss on these deposits, because they have to pay higher interest rates to those who make deposits with them.

The second point about the banks' loyalty and their limited ability to exit is that it is not only the result of regulation, but is inherent in the nature of the institutions themselves. In the least developed financial systems, banks may well be little more than institutions making leveraged investments in government securities. However, commercial banking in the case study countries creates an exposure to the overall economy through their

⁹⁴ Deputy General Manager, interviewed 2 September 2005.

⁹⁵ Senior official, Association of Lebanese Banks, interviewed 12 September 2005.

⁹⁶ Manager, Turkish bank, interviewed 6 December 2005.

commercial banking activities. Even if a bank could sell its government bonds, full exit from the consequence of default is therefore impossible. A bank is an asset with a specific use (Frieden 1991a: 96). This induces Hirschman's second conception of loyalty. While regulation (for example, reserve requirements or limitations on establishing branches abroad) reinforces this loyalty, the nature of banking is also important. The loyalty demonstrated above by the Turkish banks, largely free to establish branches and make loans (or buy bonds) abroad, demonstrates this.

This section demonstrates how, and for what reasons, the inability to exit induces loyalty. It suggests that Hirschman's first, more widely-recognised, conception of loyalty linked directly to the direct material costs of selling bonds, while important to commercial bank investors, is insufficient. The fact that full exit is impossible means that banks continue to care about the government bond market even if they sell a bond, or choose not to buy a particular new issue of bonds. Their ability to be 'quality-makers' further influences behaviour. The result is a greater loyalty than would result merely from the direct costs of exit. Three examples above serve to demonstrate this behaviour.

Differences in the ability of banks to exit, and in the loyalty they demonstrate, are linked to the financialisation of the government bond market.

In both Lebanon and Turkey, as discussed above, there is an inability to exit the government bond market fully. As a result, the banks, particularly the larger banks, demonstrate a high degree of loyalty. This loyalty has an impact on their investment decisions in government debt, and on their attitude to facilitating the further financialisation of their respective government debt markets. The situation in Brazil is not the same. International interviewees note a difference between the way Brazilian domestic investors act when compared to those in Turkey, and in particular Lebanon, with the Brazilians much more trading-orientated.⁹⁷ One Turkish interviewee also noted

⁹⁷ Brazilian locals are 'very dynamic' (emerging market debt trader, London, interviewed 18 February 2005); 'a lot more trading oriented' (hedge fund manager, interviewed 23 June 2005); 'they're a bit more

the difference.⁹⁸ Brazilian interviewees confirmed the short-term perspective of domestic Brazilian investors.⁹⁹

The situation in Brazil, then, is not the same as in Lebanon and Turkey. Brazilian banks do not see themselves as ‘quality-makers’ to nearly the same extent as in Lebanon and, to a lesser extent, Turkey. In Turkey, ‘there’s always a level at which the locals with their liquidity want to play’,¹⁰⁰ but in Brazil, ‘there’s no buyer of last resort’.¹⁰¹ A Brazilian interviewee suggests the reason, when asked if Brazilian banks would refuse to lend securities so as to prevent shorting activity in the market: the derivatives market allows short positions to be taken anyway, regardless of the attitude of the banks.¹⁰²

A key difference between Brazil and the other two case study countries is therefore the Bolsa de Mercadorias & Futuros (‘BM&F’), the Brazilian Mercantile and Futures Exchange, founded in 1983. The exchange trades futures and options on, amongst others, interest rates and currencies, and is ‘ten times more liquid maybe’ than the government bond market,¹⁰³ ‘so everybody that wants to take a sizeable position goes to

sophisticated, where they’ll go short and they’ll go long and they’ll play other things’ (emerging market debt trader, London, interviewed 17 February 2005).

⁹⁸ ‘They [Brazilian banks] are displaying more...trading type of account, rather than the Turkish banks. The Turkish banks...rather just buy Eurobonds and just sit on it, trade very seldomly but Brazilian banks...are more...trading type’ (Vice President, Turkish investment company, interviewed 6 December 2005).

⁹⁹ For example, ‘locals are...really...looking for what is going to happen tomorrow or next week. 95 per cent of the locals think like this’ (proprietary trader, Brazilian bank, interviewed 29 August 2006).

¹⁰⁰ Emerging market debt trader, London, interviewed 18 February 2005.

¹⁰¹ ‘[I]f Brazil is going up everyone wants to buy, if it’s going down everyone wants to sell it. There’s no hugely liquid market that says “if they’re going to do a billion and a half dollar in ten years, if all else fails the locals will buy it”. Doesn’t occur in Brazil. That’s why I think it’s been so choppy’ (syndicate manager, London, interviewed 16 February 2005; also proprietary trader, Brazilian bank, interviewed 29 August 2006).

¹⁰² ‘[B]anks wouldn’t lend the bonds because then people would get short and the yield would go up, but actually if people want to do that bet to go short, to pay rates, they can do that on the derivatives and that would move the bonds in the same way’ (proprietary trader, Brazilian bank, interviewed 29 August 2006).

¹⁰³ Head of trading, foreign bank, Brazil, interviewed 29 August 2006; also head of trading, foreign bank, Brazil, interviewed 4 September 2006; former senior official, Banco do Brazil, interviewed 29 August 2006; hedge fund manager, Brazil, interviewed 31 August 2006.

the futures market'.¹⁰⁴ This represents 'the biggest difference you have from other emerging economies'.¹⁰⁵ Without the derivatives market, it appears unlikely that aggressive short-term trading on movements in interest rates could take place in the volumes it does in Brazil, or such efficient hedging. The BM&F is central to the high financialisation of the Brazilian market. One of the largest private banks completes about 90 per cent of its hedging through the BM&F.¹⁰⁶ 'We tend to invest mainly in derivatives',¹⁰⁷ is a statement that could not be made in Lebanon or Turkey. The result of such a highly liquid market is that there are no 'quality-makers'. The 'repo' market (the market for the borrowing and lending of securities, allowing shorting activity) is in fact small in the Brazilian domestic government bond market, but this does not restrict aggressive trading, including taking short positions, because of the BM&F. Using the BM&F also allows traders to leverage their investments (i.e., take greater market risk with an unchanged cash investment), in one estimate allowing leverage of five times.¹⁰⁸ The ability to leverage investments increases financialisation in a market, as it facilitates the increased trading of risk. In Turkey, with a less developed derivatives market, its further development would 'fundamentally change the way I'm running my portfolio'.¹⁰⁹

Such liquid markets also have a direct influence on the ability of market actors either to 'exit' or to express disloyalty. In 1999, as Brazil suffered from the contagion of the Asian and Russian crises, the government was forced to devalue a previously pegged currency and turn to the International Monetary Fund. Lebanon in particular saw little

¹⁰⁴ Head of trading, foreign bank, Brazil, interviewed 29 August 2006. The BM&F is also structured so that trading through the exchange reduced credit exposure (head of trading, foreign bank, Brazil, interviewed 4 September 2006; also official, BM&F, interviewed 1 September 2006; research analyst, foreign bank, Brazil, interviewed 29 August 2006), which is particularly important in a very volatile market.

¹⁰⁵ Head of Trading, foreign bank, Brazil, interviewed 29 August 2006.

¹⁰⁶ Head of Treasury, interviewed 30 August 2006.

¹⁰⁷ Hedge fund manager, Brazil, interviewed 12 September 2006.

¹⁰⁸ Research analyst, foreign bank, Brazil, interviewed 29 August 2006.

¹⁰⁹ A local derivatives market 'would...fundamentally change the way I'm running my portfolio, because the embedded funding on derivatives might differ a lot from my funding base, depending on the market conditions. So just for the sake of capturing that art, I might be choosing to run a position in derivatives, or the underlying asset itself. Depending on where the relative pricing is. So next time you come, I might be telling you I had zero in discount securities because the derivatives market is much better because of this and that' (Deputy General Manager, Turkish bank, interviewed 5 December 2005).

impact from either crisis (Barakat 2003; Mosley 2003: 154). Similarly, during 2002, fear of a Lula presidency ahead of the Brazilian election resulted in very substantial falls in bond prices. Brazil was, at one point, trading at a similar level to the Ivory Coast, which was at that time experiencing a military coup (Hardie 2006). Potentially similar situations in Lebanon after the Hariri assassination, and in Turkey in 2001, saw banks there demonstrate loyalty, assisting (or at least attempting to assist) efforts to contain the situation. This did not happen in Brazil, with many banks choosing either to hedge their risk or to place bets on further price falls, and able to do so.¹¹⁰ The Brazilian banks are both willing and able to express disloyalty. Hedging can be performed in Turkey, at least partially,¹¹¹ but taking a short position is very difficult. In Lebanon, neither hedging (exit) nor shorting (disloyalty) is possible.

This is not to suggest that the contrast between Brazil and the other two cases study countries should be seen as between disloyal and loyal banks. This is too stark. The largest Brazilian banks remain ‘married to the country’.¹¹² Even if they can hedge their immediate risk from price market falls, they could not shield themselves entirely from the consequences for their business of an economic collapse caused by a government debt default.¹¹³ In 2002, a number of the larger banks did buy when the market was weak, and profited as a result.¹¹⁴ In 2002 also, there were discussions amongst some banks concerning supporting the market, but they came to nothing. The Banco Central do Brasil, not believing this was a solution (in part because the banks could not be quality-makers), would not change the rules on marking positions to market that the

¹¹⁰ ‘[I]f we had the confidence that the currency would go to four [Real to US\$], we would buy a lot of [dollars]. On the devaluation, 1999, every bank was very long dollars and every bank made a lot of money.’ In 2002, ‘we were short the currency, hedging some exposures’ (proprietary trader, Brazilian bank, interviewed 29 August 2006).

¹¹¹ ‘[W]e ride [a] certain portion of the risk but above that we hedge the risk’ (Executive Vice President, Turkish bank, interviewed 7 December 2005).

¹¹² Former senior official, Banco Central do Brasil, interviewed 11 September 2006.

¹¹³ Although, it should be noted, a further degree of financialisation, a fully functioning Credit Default Swap market for corporate debt, would materially improve their ability to do so.

¹¹⁴ Hedge fund manager, interviewed 12 September 2006; former senior official, Banco Central do Brasil, interviewed 11 September 2006.

banks believed would be necessary.¹¹⁵ The important distinction between the Brazilian banks in 2002 (and possibly the Turkish banks now) and the Turkish and Lebanese banks in 2001 and 2005 respectively, is that they had a greater ability to exit and to express disloyalty, and that many used this ability. Also, the presence of proprietary traders within some of the larger banks, trading solely to make profits on their own books, meant that there were parts of these banks which had an interest in expressing disloyalty, shorting the market if they believed it would be profitable.¹¹⁶ These proprietary trading desks act in a very similar way to hedge funds (see chapters 4 and 5),¹¹⁷ and are often a source of personnel to Brazilian (and international) hedge funds. This is in marked contrast to Turkey, where most bankers interviewed indicated their traders were not allowed to short, or faced significant constraints in doing so, and to Lebanon, where none of the bank traders could short. This difference is the result of the increased financialisation of both the Brazilian banks and the Brazilian government bond market.

Internationalisation

It has been argued above that internationalisation should be seen as part of the process of increased financialisation, but only a part. Internationalisation has an impact on banks' ability and willingness to genuinely 'exit', in all three countries. In this context, internationalisation refers to domestic banks being bought by foreign institutions, international market actors introducing financial innovation (a argument commonly used to support foreign-ownership of domestic banks; see Stallings 2006: 56), and the internationalisation of regulation (see, for example, Porter 1993, 2001, 2005). Internationalisation is most commonly seen as the reduction of capital controls. The reduction of controls on inward flows does cause internationalisation, by allowing

¹¹⁵ Former senior official, Banco Central do Brasil, interviewed 11 September 2006.

¹¹⁶ Taking outright short positions in the Brazilian market can be expensive, but this is only because domestic interest rates are so high.

¹¹⁷ Hedge fund manager, Brazil, interviewed 11 September 2006; hedge fund manager, Brazil, interviewed 12 September 2006.

international investors into a market, but this will be considered in chapter 5 on international investors. The reduction of capital controls on outward flows is directly increased financialisation: the trading of risk is made easier.

In all three countries, the three developments highlighted above have an impact on the attitude to investing in government debt. All three also increase financialisation by increasing the ability to trade risk. In the case of financial innovation this is clearly the case. In the case of foreign ownership of banks, the introduction of new technologies is one influence on financialisation, through the expertise to take greater risks on borrowers other than the government (including lending to individuals) and through their ability more genuinely to exit a country. Such exit can include leaving a country completely, which a domestic bank cannot ordinarily do. The claim that the internationalisation of regulation should be seen as contributing to financialisation appears counterintuitive; prudential regulation is aimed at limiting risk taking. It is indeed the case that Basel II (see further discussion below), the latest international regulation of banks, may reduce the ability of international banks to lend to the case study countries. However, international banks have not been large purchasers of emerging market government bonds. For the domestic banks in emerging markets, however, Basel II, if adopted, will increase financialisation in two ways. First, the ability of the domestic regulatory authorities to favour their own government bonds would be reduced. A playing field that has been heavily sloped in favour of government bonds under Basel II will be leveled somewhat. Second, banks that adopt the 'advanced' option for assessing capital adequacy will increasingly be able to set their capital requirements using their own risk management systems, reducing those capital requirements and increasing the ability to take risk. As will be discussed further below, against this must be set the expected fall in the capital adequacy ratio (the amount of capital held relative to assets) of banks in emerging market countries.

Foreign ownership of banks

In Lebanon, foreign banks are clearly far less willing to take the risk of government debt. Two foreign banks interviewed¹¹⁸ both kept their investment in government bonds to the minimum, although this minimum was above the regulatory requirement in Lebanese pounds, due to the lack of alternative lending opportunities (Moody's Investor Services 2004: 4). Whereas the domestic banks aggressively compete for deposits (*Daily Star*, 26 October 2006), matching much of these additional liabilities with increased buying of government bonds, the foreign (particularly non-Middle Eastern owned¹¹⁹) banks have been willing to pay lower deposit rates, relying on the appeal to a minority of depositors of a foreign bank. The result is slower growth than experienced by the domestic banks, but with less direct exposure to the government.¹²⁰ For some, the decision has been not to remain in the country at all. The number of banks defined by the Banque du Liban as 'foreign owned' has fallen from 17 in December 1999 to 10 in March 2006 (although Banque du Liban encouragement of bank consolidation also reduced the number of domestically owned banks, from 66 to 55).¹²¹ Foreign banks can not only trade risk, but can sell a banking subsidiary. In Turkey, while foreign investment banks are entering the market to trade securities, the emphasis of the foreign commercial banks is not on buying government bonds, but on what is frequently termed 'real banking'. This has had an impact both on banks that have been bought, and those that, at the time of interviewing, had a strategy of selling all or part of the bank to a foreign investor (IMF 2006a: 20). 'Real banking' means that foreign banks are looking more actively at lending to individual and retail customers, rather than lending to the

¹¹⁸ Treasurer and Director, interviewed 5 September 2006.

¹¹⁹ This difference in behaviour amongst the foreign-owned banks demonstrates a further difficulty in categorising banks. In Lebanon, banks with Middle-Eastern shareholding, even control, appear to act more like the domestic banks, whereas other foreign-owned banks demonstrate markedly different behaviour.

¹²⁰ 'They don't want the size gain, they don't want to grow, so they are dealing with the best corporate segment in the country. They are not taking risk. They are limiting themselves to trade finance, to short term finance...they are making private banking with the very good wealthy Lebanese guys, or they are financing the trade of the best corporate sector' (senior official, Association of Lebanese Banks, interviewed 12 September 2005).

¹²¹ Banque du Liban Quarterly Bulletin First Quarter 2006 Statistical Annex. Available at www.bdl.gov.lb/pub/qb/qb108/QuarterlyBulletin.pdf, accessed 29 January 2007.

government.¹²² In part this is a credit decision, as discussed above, but it also represents a business strategy. There is no need, in any of the case study countries, to buy or establish a full service commercial bank simply to invest in government securities. Also, as banks gain the expertise to take a broader range of risks (i.e., as they become more financialised), their demand for government bonds will fall, so it is to be expected that international banks will generally look to a wider range of risks.

In Brazil, Stallings (2006: 245) suggests that foreign banks entered the market intending to lend in areas not generally covered by local banks, but instead took advantage of high-yielding government bonds. There are important differences, however. Local banks are considered ‘pretty much [to] have an unlimited ability to purchase government...securities’, whereas ‘every single foreign bank ha[s] a cap for the amount of government securities it could hold on its books’.¹²³ Foreign banks are subject to the regulations on their parent banks’ consolidated balance sheets (see discussion of Basel II below). In a crisis, internal bank limits are frequently drastically reduced¹²⁴ (see also Santiso 2003: 24). The overall difference between domestic and foreign banks in Brazil in a period of crisis may be less extreme than in Lebanon or Turkey, because of the continuing liquidity of the market and the availability of hedging instruments, but the difference is nevertheless important. That foreign banks are able to withdraw at times of uncertainty undermines the argument that ‘foreign banks would be a positive force in the face of financial turbulence’ (Stallings 2006: 57, although the argument is not one she makes).¹²⁵ Local banks are more likely to keep financing the government, but at very

¹²² A contrast to the experience of Mexico (Stallings 2006: 70).

¹²³ Head of Trading, foreign bank in Brazil, interviewed 4 September 2006.

¹²⁴ ‘[I]n crisis normally what happens is that we get our limits diminished...I remember in 2002...I was at [a large European bank], I was involved in trade and was financing commerce....The lines dried up, we were running a \$4 billion book and suddenly we were not there for any rollovers’ (Head of Trading, foreign bank in Brazil, interviewed 4 September 2006).

¹²⁵ See also Griffith-Jones and Bhattacharya 2001: 22 on evidence of foreign banks reducing credit in a crisis in South Korea; Dages *et al.* 2000, in contrast, find foreign banks in Argentina and Mexico did not show volatility in lending; Demirgüç-Kunt *et al.* 1998 find the presence of foreign banks reduces the risk of a banking crisis; Turner 2001 concludes diversification of bank ownership is positive in a crisis situation.

short maturities.¹²⁶ Furthermore, some foreign banks have a policy of hedging their overall currency exposure to the country,¹²⁷ diminishing their likely loyalty, as well as the positive impact of the initial investment on the balance of payments.

Foreign Banks Introducing New Market Technologies

Direct evidence of international financial market actors contributing to financialisation through the introduction of new technologies is hard to find. However, in Brazil, the BM&F openly acknowledges it is modeled on the Chicago Mercantile Exchange.¹²⁸ International interviewees also see themselves as influential innovators, and as generally more ‘sophisticated’ than their domestic counterparts. A proprietary trader at a Brazilian bank acknowledged this.¹²⁹ In addition, the requirements of foreign investors to deal with highly-rated counterparts can mean that they use foreign banks, especially those established in the country, as the conduit for their more complicated investments,¹³⁰ thereby increasing both internationalisation and financialisation. Such activities can also place pressure on the regulatory authorities, as local banks push to be allowed to compete with foreign competitors.¹³¹ However, in contrast, one of the difficulties for foreign banks in Brazil was that domestic private banks had a competitive advantage in treasury operations and technology (Stallings 2006: 245), suggesting a high degree of financialisation already existed in the Brazilian market. The competition was enough for foreign ownership of Brazilian banks to fall between 2001 and end-2005.¹³²

¹²⁶ Proprietary trader, Brazilian bank, interviewed 29 August 2006.

¹²⁷ Head of sales and trading, foreign bank, Brazil, interviewed 30 August 2006; Head of Trading, foreign bank, Brazil, interviewed 4 September 2006.

¹²⁸ Senior official, BM&F, interviewed 1 September 2006.

¹²⁹ ‘[T]hey are much faster in developing products to foreigners and actually developing products that fit better to their needs’ (interviewed 29 August 2006); also senior official, Banco do Brazil, interviewed 5 September 2006.

¹³⁰ Director, foreign-owned bank, Turkey, interviewed 7 December 2005.

¹³¹ Deputy General Manager, Lebanese bank, interviewed 3 September 2005, argued, in support of being allowed to offer a particular fund to local investors, that if ‘we don’t do it, the international [banks] who come here...who have...free access to the market....without being regulated or subject to the discipline that you’re imposing on us, they’re doing it anyway, and they’re subjecting local clients and investors to these same risks you’re talking about’.

¹³² Brazil is not alone in this. Foreign ownership also fell in Argentina, Chile, China and Venezuela (Cumming 2006: 14), and in Lebanon (see above).

The Internationalisation of Regulation

Internationalisation also involves regulation following international standards (see also the discussion of IAS 39 above). Although, as already stated, not the focus of this study, regulation remains an important influence on investment decisions, and the internationalisation of regulation is particularly important in the case of commercial banks. The amount of capital banks are required to maintain against their holdings of government bonds is both a significant influence on the decision to buy securities and an example of a process that over time leads to the increased encroachment of international practices into the domestic market. The higher the capital required, the higher the rate of return the bank will require to make that loan, after adjusting for different levels of risk (Chami and Cosimano 2001: 4).

Bank regulation has historically been a domestic affair, including the setting of capital adequacy levels, but this began to change with the agreement on International Convergence of Capital Measurement and Capital Standards (the Basel Capital Accord or Basel I), which was agreed in July 1988 and phased in by January 1993 (Santos 2000: 17; Bank for International Settlements Undated). It was subsequently amended in 1996 to include open foreign exchange positions, and, most significantly for this study, traded debt securities (Santos 2000: 1). Although Basel I was an important step in the internationalisation of banking regulation, its practical impact was not hugely significant to the question of bank holdings of government securities. Local currency securities were deemed 'risk free' and had a zero capital weighting (i.e., no capital had to be held against those assets). Foreign currency bonds issued by a government were seen as slightly more risky, with a weighting of 20 per cent, but still far below the 100 per cent capital weighting applied to loans made to companies. For Turkey, an additional advantage was membership of the Organisation for Economic Co-operation and Development (OECD). This meant its foreign currency bonds also carried a zero capital

weighting.¹³³ The 20 per cent capital weighting appears to have had minimal influence in discouraging the purchase of government bonds by domestic banks. The 20 per cent remains constant, even as international credit ratings change. National regulators were able to set their own levels above 20 per cent as they deemed appropriate. So, for example, Lebanese banks' holdings of the government's foreign currency bonds were weighted at up to 50 per cent, depending on maturity. Such weightings served to combine prudential regulation with a continuing advantage for government bonds. Banks in emerging markets have also generally been required to maintain capital well in excess of the 8 per cent minimum. In Brazil, for example, the requirement is 11 per cent.

Basel I is now being superseded by Basel II,¹³⁴ originally published on 26 June 2004, and subsequently modified as a result of a consultation process.¹³⁵ Countries, led by the G10, began implementation from the beginning of 2007. All three of the case study countries appear set to follow to varying degrees. Basel II retains the 8 percent minimum capital adequacy of Basel I, but in the calculation of capital requirements and the overall regulatory framework is considerably more complicated than its antecedent (Basel Committee on Banking Supervision 2005), and considerably less favourable to lower-rated sovereign borrowers. Basel II sets risk weights for claims on sovereigns and central banks dependent on ratings, as in Appendix B, Table 9. All three case study countries have a risk weight of 100 percent. It is important to note that the Basel I domestic discretion is retained for government securities issued in domestic currency (Basel Committee on Banking Supervision 2005: 16), leading to a zero risk weighting in the case study countries. However, the change for foreign currency debt is significant, in absolute and relative terms, both for domestic investors in lower rated emerging markets

¹³³ Turkey, an OECD member since 1961, was long the only emerging market country in the OECD. Mexico joined in 1994, the Czech Republic in 1995, Korea in 1996 and the Slovak Republic in 2000. See www.oecd.org for a full list of the 30 members.

¹³⁴ For the reasons an updated regulatory standard was considered necessary, see Jackson *et al.* 1999: 2; Karacadag and Taylor 2000: 2; Barajas *et al.* 2005: 6.

¹³⁵ The extent to which this consultation process, and indeed the overall Basel process, involved, and took account of the views of, developing countries is a matter of debate. See, for example, Griffith-Jones and Persaud undated; Bailey 2005; all of whom see inadequate developing world representation. Karacadag and Taylor 2000; Carstens 2004 disagree.

(i.e., banks buying their own sovereign's debt), and for international lenders. Three important changes have occurred as regards capital requirements. First, the favourable treatment of foreign currency government debt relative to similarly rated companies is removed.¹³⁶ In both Lebanon and Turkey, lending to companies has been predominantly in foreign currency. Banks will now be able to make lending decisions without the impact of differential capital requirements. Second, the difference in required capital between investing in foreign currency bonds issued by the case study countries and, for example, US Treasuries, has widened. US Treasuries retain their zero weighting under Basel II, but Turkey would move from zero to 100 per cent, Lebanon and Brazil from 20 per cent to 100 per cent.¹³⁷ The relative attractiveness of the case study countries' government bonds would decrease, making alternative investments easier (including deposits with international banks, which will have a weighting of 20 per cent). Third, Basel II introduces requirements for 'operational risk', 'credit concentration risk', and 'liquidity risk' (Basel Committee on Banking Supervision 2005).

Concerns regarding the application of Basel II in emerging market countries are widespread (see Griffith-Jones and Persaud undated; Karacadag and Taylor 2000; Ribakova 2005; Bailey 2005). The overall impact is debated, but the greatest focus has been on the potential for a decrease in international capital flows, and/or an increase in the cost of borrowing for emerging market entities. At their worst, the predictions for increased cost for lower-rated borrowers such as the case study countries are very high.¹³⁸ There is also the potential for these flows to become procyclical.¹³⁹ Turkey is

¹³⁶ It is worth noting in this regard Demirgüç-Kunt and Detragiache's (2005) conclusion that banks with higher lending to the private sector are more vulnerable in crises.

¹³⁷ A single rating downgrade of Lebanon would push the capital requirement to 150 per cent, demonstrating also the increased influence of the international rating agencies. The government would then be better unrated from the viewpoint of capital weighting, as an unrated country, including, as one Lebanese bank interviewee pointed out, Zimbabwe, would be 100 percent risk weighted. Although provision is made for domestic rating agencies under Basel II, their approval is subject to following practices already applied by the international agencies. Further, the international agencies have been heavily involved in the establishment of domestic agencies (Sinclair 2005).

¹³⁸ See Hayes *et al.* 2002; Weder and Wedow 2002; Bailey 2005; IMF 2005a; Griffith-Jones and Persaud undated

¹³⁹ See Jackson *et al.* 1999; Weder and Wedow 2002; Bailey 2005; Barajas *et al.* 2005; IMF 2005; Griffith-Jones and Persaud undated.

possibly the most significant loser, as it also loses the benefit from OECD membership (Weder and Wedow 2002: 12; Hayes *et al.*: 111; Canakci 2005: 3). This is important because domestic commercial banks, as well as taking foreign currency deposits, also borrow internationally, reinvesting part of this money in the international issues of their own sovereign. This is particularly the case in Turkey. If banks' international borrowing becomes more expensive the ability to buy government debt is curtailed.

One obvious result of Basel II is a reduction in the capital ratios of the domestic banks. For Brazil, the intention at the time of interviewing was not to apply the Basel II guidelines for the capital weighting of Brazilian government debt, so keeping it at 0 per cent, even for foreign currency debt.¹⁴⁰ In the case of Turkey, the banking regulator, the BRSA, has calculated the impact on 23 Turkish banks. The consolidated capital adequacy ratio for these banks falls from 28.8 percent to 16.9 percent. 'The basic reasons for this decline are the high capital obligations for FX denominated Treasury papers and operational risk factor taken into account in the calculations under the new framework' (Canakci 2005: 3¹⁴¹). This leaves Turkish banks still very well capitalised, so they are unlikely to be constrained by this requirement. However, even in Turkey, there is an expectation that investment in government securities (obviously foreign currency-denominated) could be reduced.¹⁴²

In Lebanon, the capital situation is not as comfortable. At the time of interviewing in Lebanon, the Lebanese authorities were still looking at the potential implications through a task force.¹⁴³ The concern for the Banque du Liban is the continued financing

¹⁴⁰ Advisor, Banco Central do Brasil, interviewed 5 September 2005.

¹⁴¹ The report the Undersecretary of the Turkish Treasury quotes from is available at time of writing only in Turkish.

¹⁴² '[I]t would change my investment policy in the sense [of]...how much am I going to be allocating to [the] sovereign versus to corporate[s]' (Deputy General Manager, Turkish bank, interviewed 5 December 2005).

¹⁴³ Senior official, Banking Control Commission, Lebanon, interviewed 7 September 2005.

of the government.¹⁴⁴ One interviewee, speaking about the banking sector in general, expected a fall from around 20 per cent to 10 – 12 per cent, and did not expect any significant impact.¹⁴⁵ The IMF (2006c: 20) expects a fall to around 10 per cent. Not all Lebanese interviewees agree that a reduction in capital to these levels is unimportant. One senior official at one of the largest banks concluded that ‘all this [Basel II] has forced us to really start looking at a...cap on our government exposure’.¹⁴⁶ Two banks interviewed were looking to raise additional capital because of the new requirements,¹⁴⁷ and one smaller bank interviewed was being sold ‘in order to compete in the market and to respond to all the Basel II requirements’.¹⁴⁸ Such activity is not all contributing to further internationalisation, however. One bank’s 50 per cent foreign shareholder was looking to sell its stake, ‘but if Basel II [did not]...exist, they would be happy to stay’.¹⁴⁹

A further impact of Basel II on emerging market banks has received even less attention. The focus on improved risk management, central to the banks being able to receive the most favourable regulatory treatment, has prompted banks to work to upgrade their internal risk management systems. The source of the necessary technology is frequently international vendors. ‘Now we are shopping around in the world with big banks to buy risk management information system[s]’.¹⁵⁰ This is also the case for some banks in Brazil.¹⁵¹ These systems appear likely to introduce international practices such as ‘Value at Risk’, which also raise issues of pro-cyclicality (see chapter 5 on international investors). The impact appears likely to be less in Brazil and Turkey, where such systems are already widely used (including by the Turkish BRSA). It could be argued that risk management will improve where such systems are introduced (which is

¹⁴⁴ ‘The governor is reluctant to implement [Basel II]...fearing that if he implements, banks will not be able to continue to fund public debt’ (Deputy General Manager, Lebanese bank, interviewed 3 September 2005).

¹⁴⁵ Senior official, Association of Lebanese Banks, interviewed 12 September 2005.

¹⁴⁶ Interviewed 8 September 2005.

¹⁴⁷ Senior Manager, Lebanese bank, interviewed 7 September 2005; Deputy General Manager, Lebanese bank, interviewed 3 September 2005.

¹⁴⁸ Treasury Manager, Lebanese bank, interviewed 9 September 2005.

¹⁴⁹ Director, interviewed 5 September 2005.

¹⁵⁰ Senior official, Association of Lebanese Banks, interviewed 12 September 2005; also Deputy General Manager, Lebanese bank, interviewed 3 September 2005.

¹⁵¹ Senior official, Banco do Brasil, interviewed 30 August 2006.

certainly how Lebanese interviewees presented the situation). It is nevertheless further internationalisation of market practices.

Considerable debate exists as to the extent to which, and the reasons, emerging market countries feel compelled to implement Basel II, and felt they had little choice regarding Basel I (Bailey 2005). One of the main incentives appears to be banks' reputation with international depositors and lenders.¹⁵² Major banks in emerging market countries are reported to have pushed their own regulators for adoption of Basel II (IMF 2005: 5), and of 107 countries surveyed by the IMF, 100 intended to implement (*ibid.*: 3).

Nevertheless, national discretion continues within the Basel II regime; the IMF (2005: 7) sees 40 options of national discretion. In the three case study countries, Brazil appeared at the time of interviewing to be planning to use considerable discretion, not only maintaining a 0 per cent risk weight for all government bonds, but not using rating agencies to determine capital weightings, and having other government bonds at 50 per cent (or 100 per cent if the country had defaulted in the past).¹⁵³ Lebanon was seeking special treatment for foreign currency bonds to reflect the highly dollarised nature of the economy.¹⁵⁴ The most important latitude for domestic regulators, however, appears to be in how far over the 8 per cent minimum bank capital requirement of Basel II regulators require their banks to stay. Basel II covers more risks, and may increase the capital required for government bond holdings. It would therefore appear to justify a lowering of the minimum level in some countries. Such a lowering could simply compensate for the higher risk weightings.

This analysis of Basel II has so far not included an important part of the accord's influence on financialisation. The choice of the 'advanced' approach for the calculation of capital requirements allows banks, subject to the local regulator's approval, to use their own internal risk management systems to determine the required level of capital

¹⁵² Senior official, Association of Lebanese banks, interviewed 12 September 2005; Bailey 2005: 40.

¹⁵³ Advisor, Banco Central do Brasil, interviewed 5 September 2006. The Brazilian banks had responded with a counterproposal that maintained OECD countries at 0 per cent.

¹⁵⁴ Senior official, Banking Control Commission, Lebanon, interviewed 7 September 2005.

they hold for particular risks (Basel Committee on Banking Supervision 2005). The expectation (not least from the banks that wish to apply the advanced alternative) is that this aligning of regulatory risk with banks' own calculations of economic risk will reduce the capital they are required to maintain. This is particularly likely to be the case with the capital required for more sophisticated activities. By making the taking of risk easier, therefore, this part of Basel II is a clear example of increased financialisation. The pace at which banks will choose (and be allowed to) follow the advanced approach remains unclear, but the expectation must be that the largest, internationally active banks will do so, including the foreign owned banks. They will be at a competitive disadvantage if they do not.¹⁵⁵

On balance, Basel II will serve to increase financialisation. The overall ability of domestic banks to take particular risks may decline initially as Basel II is implemented, because of higher capital requirements, but unless domestic regulators maintain current capital adequacy levels, overall risk taking should not decline. Basel II is significant to this study for a number of reasons: By limiting the favourable capital treatment of emerging market government international bonds, and increasing the advantage enjoyed by developed country bonds and bank deposits, it makes it easier to take risks other than that of a bank's own government (thereby reducing the relative importance of regulatory influences on investment); it represents a further convergence of bank regulation around international standards; and increasingly, as the advanced approach is adopted, banks will use their own risk models to assess capital requirements, and be able to take more risk as a result.¹⁵⁶ For all these reasons, on balance Basel II should be seen as a move towards greater financialisation.

The above section on internationalisation demonstrates both how internationalisation leads to increased financialisation (and therefore reduced government policy autonomy), but also how internationalisation should be seen as only a part of the influences that

¹⁵⁵ Advisor, Banco Central do Brasil, interviewed 5 September 2006.

¹⁵⁶ Although '[t]here are some indications that the criteria used by supervisors to approve the use of internal risk models will be quite tough' Porter (2005: 64).

determine the overall level of financialisation. Internationalisation, as described here, is one of the ways by which the trading of risk becomes easier, and banks have alternatives to investing in government debt.

Conclusion

This chapter has argued that domestic banks can be seen as demonstrating loyalty in their financing of their governments. This, by making financing and the management of crises easier, increases the autonomy of governments. Furthermore, it is suggested that increased financialisation of the government bond market decreases this loyalty. Financialisation increases the ability to exit, and to express ‘disloyalty’. It also reduces the likelihood that banks will see themselves as ‘quality-makers’, because of a greater diversity both of financial market actors and of alternative financial market instruments. A contrast is drawn between the high level of financialisation in Brazil, and lower levels in Turkey and particularly Lebanon.

It is clearly important that this argument is not pushed too far. As the IMF (2006b) notes in the case of Lebanon, a dependence on banks for financing is also a dependence of those banks’ depositors. More fundamental to this argument, however, is the fact that when banks fail, governments must address the consequences, financially and/or politically. In the case of Turkey, the restructuring of the banking system after the 2001 financial crisis cost 32 percent of GDP (Josefsson and Marston 2005: 58; see Green 1999 and Stallings 2006 on the costs in Latin America). Prudential regulation of banks, so central to preventing such crises, while it can serve to direct investment towards government bonds, can also conflict with the interests of government financing. The regulation of maturity mismatches (i.e., borrowing short and lending long) is an obvious example. This interdependence between government and banking system is most clearly articulated in Lebanon, where the banks are confident the central bank will ensure their

investment in government bonds is profitable.¹⁵⁷ The strongest critics of this interdependence argue that it represents capture of government policy by a narrow interest group which enhances its profitability through high Lebanese pound interest rates, including as a direct recompense for the zero interest deposits after Paris II.¹⁵⁸ Labaki (2003: 193) considers the banks as part of the Lebanese problem: ‘For fear of displeasing the banks, the government was not able to reduce its debt service payments’. It is important to note, however, as discussed briefly in chapter 1 and more fully explored in chapter 5, that Lebanese banks are buying bonds international investors are unwilling to purchase.

The oligopsonistic nature of domestic investors in some emerging market countries potentially increases the effectiveness of voice through the greater damage from potential exit (Hirschman 1970: 41; see also Haggard 2000: 24¹⁵⁹). Nevertheless, the loyalty of domestic banks is important to government policy autonomy. The ability of a government to rely on that loyalty, and be confident in the inability to actively express disloyalty, allows it to borrow more than they would otherwise, and can help the authorities to keep control in a potential crisis situation. In the case of Brazil, it has been shown that banks were willing to short government bonds or the currency in a crisis, leading potentially to greater volatility.¹⁶⁰ The contrast with Turkey in 2001 and Lebanon in 2005 is marked. Banks demonstrate a greater degree of loyalty, and a greater capacity to act upon their loyalty, in a less financialised system, in Lebanon rather than in Turkey and, particularly, than in Brazil. This is a large part of the reason that Lebanon can sustainably borrow far more relative to GDP than Turkey, which in turn can borrow more than Brazil. Government policy autonomy is higher in Lebanon as a result. This

¹⁵⁷ ‘[T]he Central Bank knows that the only sector that could finance the Lebanese public deficit is the banks in Lebanon. So Central Bank always try to let the banks make money because they are the sole investors’ (Senior Manager, Lebanese bank, interviewed 7 September 2005).

¹⁵⁸ ‘[Y]ou have the cartel, who has kidnapped the state’ (former government minister, interviewed 6 September 2005).

¹⁵⁹ See Haley 2001 on oligopsony in emerging markets equities. See also Maxfield 1997: 41 and Baer and Hargis 2000: 204 on emerging market bank lender oligopsony.

¹⁶⁰ It must be recognized, however, that the ability of the banking system to survive the extreme volatility in both 1999 and 2002 was central to the speed of recovery.

chapter has not argued that any government that borrows exclusively from its own domestic banks has complete policy autonomy. However, the type and nature of the investors that own government bonds matters to government policy autonomy. The loyalty of those investors is influenced by both their financialisation and the financialisation of the markets in which they invest.

Chapter 3

Individual Investors

Introduction

This chapter deals with the first significant financialisation in a government debt market: individual investors moving from being depositors in commercial banks to being direct owners of their own government's debt. Individuals have an increased ability to trade a risk which, it can be argued, they in part assume as bank depositors (especially in Lebanon and Turkey) – the credit risk of the government. Previously individuals only made deposits, the vast majority 'time deposits'¹ that cannot be withdrawn without a penalty before they mature. Part of this money is invested in government debt by the banks. In buying government bonds, individuals now own a government security that, if they choose, they can sell. It is this increased ability to trade risk that is the definition of financialisation in this thesis. Rather than decreasing the government's autonomy from the preferences of international investors, it is argued here that this initial, very limited financialisation actually increases it, even relative to financing directly from banks.

In its focus on the investment preferences of individuals the chapter will therefore argue that domestic individual investors demonstrate loyalty, continuing the theme of the previous chapter. The loyalty discussed here is, however, its more common usage, as the result of 'the high price for exit' (Hirschman 1970: 96) rather than Hirschman's second conception of loyalty. Clearly, individual investors are ordinarily too small to see

¹ Time deposits are deposited for a pre-agreed period, in return usually for a higher interest rate, but cannot be withdrawn early without penalty. In Lebanon, Lebanese pound time deposits are 13 times as large as demand deposits (May 2007, www.bdl.gov.lb, accessed 10 August 2007). In Turkey all time deposits are 5 times as large as demand deposits (7 August 2007, www.bddk.org.tr, accessed 10 August 2007). In Brazil, the ratio is just under 5 times (April 2007, www.bcb.gov.br/?BULLETCR, tab2-13i, accessed 10 August 2007).

themselves as ‘quality-makers’, as is required in Hirschman’s second conception of loyalty. This chapter will continue some of the arguments regarding loyalty discussed previously, however, by suggesting that the high price of exit that engenders loyalty should not be seen as solely the result of regulation constraining the opportunities for exit (‘enforced loyalty’), but is inherent in the nature of individuals as investors. Financialisation, the increasing ability to trade risk, is therefore not only the result of deregulation or liberalisation, but is rather inherent in the nature of individuals as investors. Specifically, the focus will be on the particularly high cost of information, and transaction costs more generally, for individual investors in purchasing securities across borders, both absolutely and relative to better-resourced institutional investors. These information costs, it will be argued, lie at the heart of the very high home bias of individual investors (especially those below the very wealthy), and their confidence in their own government’s bonds as the, or one of the, ‘risk-free’ assets available to them.

The creation of a government securities market, as argued in previous chapters, may well mask the fact that the holders of that government debt are in reality still commercial banks, in effect still lending directly to the government. In an extreme version of this (Lebanon, of the case study countries, being the closest to this extreme), there is little financialisation. The important first step is therefore the partial disintermediation of the banks. This first step can occur either in the direct ownership of government securities by individuals, as has been the dominant process in both Lebanon and Turkey, or by a change in the institutional nature of intermediation, with the development of mutual funds and pension funds, as has largely been the case in Brazil (see chapter 4). Therefore, the process of financialisation should not be seen as following a single, dependent, path, as might be implied in the ordering of this and the following chapters. Nevertheless, in both Lebanon and Turkey, individual investment in government debt was the first stage of financialisation of the government debt market.

Individual investors are loyal investors. Their higher costs of exit relative to banks compensate for the fact that they cannot be ‘quality-makers’, and therefore are not

subject to Hirschman's second, reinforcing conception of loyalty. In addition, individual investment in government securities means all that investment finances the government, whereas money deposited in a bank is only partially reinvested in government debt. Therefore, the presence of individual investors, while representing an increase in the financialisation of the government bond market, serves to increase government policy autonomy. The initial move to the right along the autonomy curve sees the curve slope upwards, because government policy autonomy increases.

Chapter Structure

This chapter will start by considering the actual extent of individual investors' involvement in the government bond markets of the case study countries. It will then consider the nature of individuals as investors, concentrating on: the higher home bias of their investments relative to other investors; their willingness to maintain under-diversified portfolios; their 'buy and hold' investment strategy (including a reluctance to take losses); and the confidence individual investors have in the creditworthiness of their own governments.

Individual Investor Ownership of Government Debt

This section considers the actual extent of individual ownership of government debt in the case study countries. Brazil has seen little direct individual investment in government debt. As set out in appendix B, table 6, individual investors directly own only 0.16 per cent of outstanding domestic government securities, and so are insignificant to government financing. They prefer to invest through mutual funds. This is despite attempts by the Brazilian Treasury to attract individuals, particularly through internet access to auctions of government securities, 'Treasury Direct'.² Reasons given by interviewees as to why Treasury Direct has not yet developed varied, but were mainly

² Senior official, Ministry of Finance, Brazil, interviewed 6 September 2006; trader, foreign bank, Brazil, interviewed 29 August 2006.

a lack of familiarity³ and the fact that the investment is not totally direct, but has to come through a bank. Banks are not particularly interested in promoting this system rather than their highly-profitable mutual funds.⁴

In Lebanon, however, individual investment in government bonds is important. 20.6 per cent of domestic securities are held outside the banking system. This includes government agencies such as the social security fund (NSSF). The NSSF held LP1,359 billion of Treasury bills at the end of 2004 (IMF 2006e: 8), or 38.8 per cent of total then held outside the banking system⁵ (with NSSF holdings of Treasury bills declining over the previous 2 years as its bank deposits increased). The 20.6 per cent figure also includes any investment by corporations (which was not noted by interviewees). There is still a significant volume of individual investment. This buying of government bonds by individuals is a relatively recent phenomenon, but the central bank now estimates that 20 – 25 per cent of Lebanese pound government securities are being sold to individuals.⁶ For international debt, it is necessary to rely on interview evidence, as no official figures exist. Banks interviewed report selling varying amounts to individuals, US\$10 – 20 million per issue (at a bank which might buy US\$100 million),⁷ up to 30 per cent⁸ and below 25 per cent.⁹ In all cases, however, it was believed that this individual interest was significant and increasing. The starting point for the interest was Banque du Liban's selling of a 3 year Lebanese Republic Eurobond at a relatively high interest rate of 10.25 per cent, the result of the central bank exchanging with the Ministry of Finance Lebanese pound-denominated Treasury bills for US dollar Eurobonds, thereby lowering the government's financing costs.¹⁰ Since that time, Lebanese government international

³ Trader, foreign bank, Brazil, interviewed 29 August 2006.

⁴ Senior official, Ministry of Finance, Brazil, interviewed 6 September 2006.

⁵ Total holding outside the banking system from Banque du Liban, www.bdl.gov.lb, accessed 21 March 2007.

⁶ Senior official, Banque du Liban, interviewed 8 September 2005.

⁷ Head of Treasury and Capital Markets, interviewed 9 September 2005.

⁸ Deputy General Manager, Lebanese bank, interviewed 2 September 2005.

⁹ Executive Adviser to Chairman, Lebanese bank, interviewed 8 September 2005.

¹⁰ Senior official, Banque du Liban, interviewed 8 September 2005. The central bank does not publish figures for bond purchases by individuals.

issues have returned to the more usual yields of 7 – 9 per cent, but there has continued to be individual investor interest, if in lesser amounts.¹¹

The experience of Turkey with individual investors is in many ways similar to Lebanon, but is of longer standing. In the domestic government securities market, as of 27 October 2006, 38.6 per cent of ‘market’ securities (i.e., held outside the public sector) was held by ‘Non Bank Residents’¹² (see appendix B, table 4), a figure that excludes mutual funds (which represent only 5.7 per cent), and is more than twice the figure for non-resident (i.e., international) investors.¹³ Companies are also investors, but most ‘non bank residents’ are individuals.¹⁴ A Treasury official¹⁵ estimated that around 25 per cent of outstanding domestic government securities were held by individuals. Over certain periods (for example, 2001 – 2003), they were the most significant investors in the market,¹⁶ and they will at other times act as ‘a cap on interest rate level[s]’.¹⁷ This is not restricted to a small number of very wealthy individuals, even if the wealthiest are likely to dominate: in one bank interviewed (in the top five in terms of total assets at end 2005¹⁸) about 250,000 customers had YTL10 billion (US\$7 billion) invested in domestic government securities.¹⁹ The trigger for Turkish individual investor interest in their own government’s domestic debt securities was also the relatively high interest rates (if far

¹¹ ‘[T]he banks are not paying more than 4, 4½ per cent. When we kicked in our bond at 10¼, people at first were afraid...he’s not used to holding...paper versus a deposit. So when they started..., one person tells the other about this thing and when you’re getting 10¼ per cent on the dollar, even more than the Lebanese pound and you’re holding a dollar with no foreign currency exchange risk,...the balls start kicking in. So...our latest issue is at 7 3/8, 7 7/8, people go and from the beginning...they place their orders because they read newspapers, they read that...the Republic is issuing, and they go to their banks and they place their orders. So from the beginning...we’re seeing demand by the public’ (senior official, Banque du Liban, interviewed 8 September 2005).

¹² I.e., investors resident in Turkey other than commercial banks.

¹³ The non-resident figure is also likely to include tax-driven ‘round tripping’ by domestic investors, taking money offshore and reinvesting in Turkey (economist, Turkish research institute, interviewed 2 December 2005).

¹⁴ Manager, Turkish bank, interviewed 6 December 2005.

¹⁵ Department Head, interviewed 2 December 2005.

¹⁶ ‘[D]uring the years...2001 to 2003, up to the...Iraqi crisis, the Turkish retail was the most powerful player in the financial market. [T]here wasn’t enough foreign investors, there wasn’t enough institutional investors as well’ (Head of Treasury, Turkish bank, interviewed 7 December 2005).

¹⁷ *Ibid.*

¹⁸ Banks Association of Turkey, www.tbb.org.tr/english/book2005/tables/table%201.xls, accessed 11 January 2007.

¹⁹ Manager, Turkish bank, interviewed 6 December 2005.

higher than in Lebanon) available at a time of economic uncertainty. In Turkey, this occurred in 1994,²⁰ and was repeated in the crisis of 2001 (see below).

Turkish individuals are also significant investors in the government's international bond issues. As of 22 December 2006, they held YTL3,565 million (US\$2,482 million) of Eurobonds,²¹ or 6.8 per cent of the total outstanding international bonds.²² It should be noted that this figure, although not large, is a percentage of bonds which are ordinarily, even in IMF calculations of debt sustainability, assumed to be held by international institutional investors (IMF 2006a: 52).²³ Potentially adding to the 6.8 per cent, there has long been an assumption that Turkish government Eurobonds sold to German banks were being on-sold to members of the Turkish diaspora, although some interviewees doubted this.²⁴ However, a Turkish Treasury interviewee involved in international borrowing did believe that much of the investment by Swiss private banks in these bonds was likely to be on behalf of wealthy Turks holding money offshore.²⁵

Individuals as Investors in Government Bonds

In this section, the preferences of individual investors in government bonds will be considered. The focus will be on Lebanon and Turkey, as these are the two countries, as shown above, that have significant individual holdings of government bonds. The study of individuals as investors has been largely confined to developed world equity markets, and can be seen as broadly divided into two distinct areas of analysis. One focuses on the transaction costs, including informational disadvantages, suffered by individual

²⁰ 'The TL investors were in some ways attracted to TL bonds in 1994,... the first most terrible crisis we had experienced, the 3 months government debt interest rates went up to 250 [sic] per cent' (Manager, Turkish bank, interviewed 6 December 2005).

²¹ Figures provided by Turkish Treasury official, e mail communication, 8 January 2007, based on BRSA figures.

²² Figure for total outstanding as of end-November 2006 (www.hazine.gov.tr/english/kaf/CG-ExtDebtStock2006.htm, accessed 4 January 2007).

²³ A further 0.6 per cent of the outstanding international bonds is held in custody by Turkish banks on behalf of non-resident individuals. These investors use of a Turkish bank would suggest they may well also be Turkish.

²⁴ Syndicate Manager, London, interviewed 16 February 2005.

²⁵ Senior official, Turkish Treasury, interviewed 30 November 2005.

investors, and their attempts to overcome these deficiencies. The other, based around behavioural finance, considers less rational decision-making, which is generally seen as being more prevalent amongst individual than institutional investors; individual investors are therefore commonly seen as the explanation for a number of apparently irrational market phenomena. Individuals are seen by some as noise traders, trading ‘in response to changes in expectations or sentiment that are not fully justified by information’ (Schleifer and Summers 1990: 23; see also Black 1986). As a result, they achieve suboptimal returns (De Bondt 1998), if only because of transaction costs (Schlarbaum *et al.* 1978; Barber and Odean 2000), often incurred as a result of overtrading (Odean 1999). Individuals make poor investments as a result of buying those equities which attract their attention, rather than systematically making the optimal choice (Barber and Odean 2003). They are, however, ‘tax-savvy’ (Barber and Odean 2004). Importantly for this study, individual investors hold under-diversified portfolios, which also produce sub-optimal returns (De Bondt 1998), with an even stronger home bias than institutional investors (Zhu 2002; Kumar 2004; Goetzman and Kumar 2003, 2005). Individual investors can therefore provide at least some of the explanation for such seemingly irrational observed phenomena as the ‘January’²⁶ (Sias and Starks 1997; Ritter 1988) and ‘weekend’²⁷ (Lakonishok and Maberley 1990; Abraham and Ikenberry 1994, although Sias and Starks 1995 disagree) effects. Looking specifically at an emerging market, Taiwan, Lee *et al.* (1999) conclude that small individual investors are ‘losers’ who would be better delegating their investment decisions to professionals. Others have questioned whether individuals really are poor investors, seeing decisions, while based on age, income level and gender, as still rational (Lewellen *et al.* 1977; Bodie and Crane 1997). Schlarbaum *et al.* (1978) show that individual and institutional investors achieve similar returns (see also Jackson 2003; Kaniel *et al.* 2004); some individuals can also outperform the market (Barber *et al.* 2004; Coval *et al.* 2005).

²⁶ Small capitalisation stocks tend to outperform around the year end.

²⁷ The propensity of stock returns to be relatively weak between the close of trading on Friday and the Monday close.

Conclusions from this literature must be cautious, given that financial markets are different, and most of the analysis is regarding (possibly more efficient) developed country markets. This study will continue to see the investment decisions taken as rational in their nature, and takes a number of important points from the developed equity market literature, all of which have potential relevance for domestic individuals as investors in their own government's bonds. All of these points suggest the positive influence of individual investors' loyalty on government policy autonomy in the case study countries. The following sections will focus on the stronger home bias of individuals, the fact that individuals are content to maintain under-diversified portfolios, individuals' reluctance to take losses, and on the confidence individual investors have in the creditworthiness of their own government.²⁸ It will be argued that the conclusions reached in the literature on (mainly) developed world equity market investors do apply to individual investors in government bonds in the case study countries. Overall, these points, in the main, fit closely with the idea of loyalty, linked to the high cost of exit as a result of transaction costs. The high cost of exit considered here is not the result of direct regulatory action by the government; it is rather inherent in the nature of individuals as investors. Individuals in both Lebanon and Turkey are not generally prevented by government regulation from choosing alternative investments (although the Turkish government has discouraged the development of a corporate bond market [World Bank 2003: 55]²⁹), and can move money abroad. It is in Brazil, where the direct holdings of government bonds are lowest (although see the discussion of mutual funds in chapter 3), that capital controls have historically been the tightest.

²⁸ This greater confidence could be explained from a constructivist perspective, but the difficulties with such an approach were outlined in chapter 1. However, a rationalist analysis is not without problems. It is difficult, for example, to see individuals as better informed than institutional investors from the same country. This potential for greater confidence is therefore acknowledged but not formally included in the analysis here.

²⁹ Companies were not permitted to pay an interest rate higher than the government, and when this was lifted, corporate bonds remained subject to withholding tax, which government bonds were not. From the beginning of 2006, taxation of all investments was equalised.

Home Bias is Higher for Individual Investors

Home bias is stronger in individual than institutional investors, including in banks when they invest the deposits they receive. It is to be expected that individuals will maintain a greater percentage of their investments in the home market. The study of individuals shows a clear local bias: within the United States, individual investors hold the equities of companies local to their area, not just their country. Zhu (2002) postulates that this local bias cannot be seen as solely the result of traditional information asymmetries, but also of ‘non-fundamentally based familiarity’ (see also Kumar 2004), matching closely the oft-expressed view amongst the interviewees in this study (talking obviously largely in their professional capacities) that they understood their countries better than those living abroad. This understanding comes from such information sources as, for example, ‘being in the country and smelling the atmosphere’³⁰ or watching or reading the local news constantly.³¹ Ivković and Weisbenner (2005) suggest there may be some truth in this view, demonstrating that local knowledge leads to superior investment returns. A number of interviewees also made this point specifically, noting the difficulties of investing abroad compared to at home, particularly in another emerging market (see chapter 1).

Individual investors are therefore faced with generally unacceptable costs of gathering information in enough detail that they can be as confident about investing abroad as they are about their own country. Lease *et al.* (1974) show how little U.S. individual equity investors spent gathering information on a market in which they were invested, so the issue may be the cost of information relative to individuals’ low valuation of that information, rather than the absolute cost of information.³² Either way, cross-border investment involves higher information costs. This is not only the fundamental

³⁰ Head of Trading, foreign bank, Turkey, interviewed 5 December 2005.

³¹ Hedge fund manager, Brazil, interviewed 11 September 2006; Executive Vice President, Turkish bank, interviewed 7 December 2005.

³² Even for institutional equity investors, Gehrig (1993) sees better information about domestic equities as sufficient to explain home bias.

information that would ordinarily inform investment decisions (and is the basis of, for example, Mosley's [2003] analysis) – it is also 'non-fundamentally based familiarity', based on living in a country, perhaps also growing up in it. Such knowledge could include both what could be acquired from outside a country – by way of newspapers, television and the internet, for example - if the cost was borne, but may be 'tacit knowledge' (Howells 1996: 92), effectively impossible to acquire, regardless of cost.³³ Investors' confidence in their knowledge of their home country further raises the effective cost of exit, because they would want to know another country equally well to invest there. The home bias for individual investors therefore represents an example of loyalty engendered by the high cost of exit, leading to a greater ability for the government to raise finance.

Individuals Accept Under-Diversified Portfolios

The above section in part explains why individual investors are content to maintain under-diversified portfolios, even if, as some have argued, this results in poor investment returns (De Bondt 1998; Goetzmann and Kumar 2003, 2005), and despite the strictures of theories of optimal portfolio allocation. Although the banks discussed in the previous chapters are also relatively under-diversified when compared to international portfolio investors, individuals (excepting the extremely wealthy) in the case study countries rarely diversify their investments away from government and bank risk. So money invested directly in government securities by individuals represents a greater share for the government than if banks intermediate. The reasons for this under-diversification lie, once again, in transaction costs. Calvo and Mendoza (2000a, 2000b) focus on institutional investor incentives to acquire information in crisis situations when considering sales from a pre-established, diversified portfolio. However, the assumptions regarding the cost of information gathering also hold when applied to the

³³ An institution could always acquire such tacit knowledge by hiring the right employees, if the cost was worthwhile, making an analysis in terms of transaction costs still valid. For individuals, however, it is more reasonable to see this as impossible. Even if an individual can hire, directly or indirectly, the required expertise, agency issues remain.

decision as to whether to bear the cost of the information gathering necessary for an initial investment. Indeed, the cost of acquiring information regarding a new country is higher than updating information on a known investment destination.

Dornbusch (2000) rightly notes that in reality, financial intermediaries serve to dramatically reduce the cost of information gathering. However, individual investors, as generally offering the lowest volumes of business, are the least likely recipients of the attention of those financial intermediaries (the large international investment banks) that can provide information on a wide range of alternative markets. In particular, investors in emerging markets, with lower overall business opportunities and high entry costs for international financial intermediaries (compared to, for example, expanding in an existing market), are even less likely to receive this information. One interviewee considered US\$100,000 as the minimum required to establish a bank account offshore.³⁴ Establishing an individual securities trading account with an international financial intermediary would require at least as much.³⁵ Direct transaction costs (fees) for cross-border investments are also likely to be higher, as is usual in developed countries. As with bank deposits, however, other factors also have an impact. Initiatives against money laundering and tax avoidance have significantly increased the bureaucratic difficulties of establishing accounts abroad, and for Lebanese residents in particular, US action on terrorist funding post-September 11 adds to the problems (on this point for Pakistanis, see Kapur 2005: 352), including potential concerns regarding the unjustified freezing of accounts. It can be assumed, therefore, that most individual investors in the case study countries would not be able to bear the transaction costs necessary for diversification, and some may be unwilling to face other risks. This is despite the fact that, arguably, the more volatile economies and financial markets of these countries give

³⁴ Lebanese lawyer, London, interviewed 21 October 2005; also 'the small savings accounts...it's not easy for them to...set up and transfer their money to Switzerland, to London ...and the cost is too high for them. So they know the only thing they can do [is]...buy dollars at least and stay in Lebanon' (Senior Manager, Lebanese bank, interviewed 7 September 2005).

³⁵ As a (perhaps extreme) example, when the US investment bank Morgan Stanley announced plans to sell its UK personal client subsidiary, it declared a strategy of concentrating on international individual clients with assets of at least US\$10 million (*Financial News*, 2 October 2006).

those exposed to that volatility a greater incentive to diversify their risk, or optimise their portfolio allocation, and therefore a greater incentive to bear the transaction costs necessary for that diversification.

The importance attached to information is demonstrated by the strategies of more wealthy Turkish investors when they do invest offshore. As they do at home, these investors focus on countries and/or companies where their business dealing gives them confidence in their knowledge, rather than acquiring the necessary information through alternative analysis³⁶ (see Zhu 2002 on ‘non-fundamentally based familiarity’). This limits the number of countries in which even these wealthier investors will invest, and most investors lack the knowledge acquired from international business activities. The incentive to invest abroad for these Turkish individuals is also telling: it appears far more about increasing returns than diversifying risk. Facing the fall in returns on Turkish Eurobonds, wealthy Turks invest in those countries and companies that offer increased yields.³⁷ While their knowledge of the countries decreases risk, in their view, the aim is not portfolio diversification. This seeking of higher returns is important to another cost of exit. As less creditworthy emerging markets, the case study countries generally offer higher yields. Therefore, *ceteris paribus*, increasing return involves investment in even lower credits, and ‘as...an emerging markets investor...we terribly know what emerging market means’.³⁸ US Treasury bonds, while low risk, yield less than the US dollar-denominated bonds of the investor’s own government. Buying low risk, lower yield bonds is an option only the most-wealthy are likely to follow. Banks, however, do reduce income in order to diversify risk. Banks place deposits with

³⁶ ‘Something they are acquainted with, because for instance we have some customers...doing business with the CIS countries and Russia, they’re active in the automotive industry, they are selling parts to the companies there. So they know the company’ (Vice President, Turkish investment company, interviewed 6 December 2005).

³⁷ [W]here [do] our clients invest right now? Russian corporates [i.e., bonds issued by Russian companies], Brazilian corporates plus government [bonds]...Sometimes Ecuador. Why? Because those people, for... more than 10 years, they invested in Turkish Eurobonds and they got nearly 8 per cent, 9 per cent 10 per cent, sometimes 11 per cent returns from their investment. Now they are not happy with their 5 per cent, 6 per cent returns. They are looking for [the] same level [of] returns [as they previously enjoyed on Turkish Eurobonds]’ (Vice President, Turkish investment company, interviewed 6 December 2005).

³⁸ Manager, Turkish bank, interviewed 6 December 2005.

international banks or invest in G7 government securities – Lebanese banks potentially at yields below the interest rates they pay to depositors – in order to preserve liquidity and diversify risk.

A diversified portfolio would therefore face multiple costs of exit: in information (if that information can in practice be acquired at all); in the transaction costs of dealing in overseas securities; in the greater risk necessary to increase returns; and in the loss of return if risk is reduced. All of these costs of exit increase loyalty, and none are significantly influenced by regulation. This is not enforced loyalty, but loyalty that is the result of the nature of investment for individuals.

Individuals are ‘Buy and Hold’ Investors

Although individuals have an increased ability to trade government risk as a result of this limited financialisation, they rarely utilise this option. They tend to ‘buy and hold’ their investments rather than actively trade.³⁹ Stallings’s (2006: 126) assessment of individual investors in Latin America as ‘much more likely to trade frequently’ disagrees with this view, as does the view that illiquidity in Latin American bond markets will discourage individual investors (Borensztein *et al.* 2006: 8). Certainly, the evidence is that Brazilian individuals value liquidity highly, as will be discussed in chapter 4. In Lebanon and Turkey, however, direct investment in government bonds is an alternative to bank time deposits. This was shown most clearly in the case of Turkey by the fall in individual investment in government securities in 2005 when competition for deposits pushed their interest rates above Treasury bill yields.⁴⁰ The focus, especially in the domestic bond market, is on short-term investments; in the case of Turkey,

³⁹ Head of Treasury and Capital Markets, Lebanese bank, interviewed 9 September 2005; ‘local retail clients do not follow the market that much and they only look how much they receive at the end of the maturity. So they don’t trade much’ (Director, foreign bank, Turkey, interviewed 7 December 2005).

⁴⁰ Economist, foreign bank, Turkey, interviewed 5 December 2005; Head of Treasury, Turkish bank, interviewed 7 December 2005; Department Head, Turkish Treasury, interviewed 1 December 2005.

generally below a year.⁴¹ It is this short-term investment perspective which is one of reasons given for encouraging the development of an institutionally-based capital market (see, for example, World Bank 2003: 7). However, this perspective needs to be adjusted slightly on the basis of the experience in these two countries, at least as concerns individuals' investments during times of stable market conditions. First, the expectation that individual investors will buy shorter maturity securities encourages banks to buy longer maturities at higher yields, confident that they can then sell these to individuals when the repayment date is nearer.⁴² Second, at repayment, many individuals renew their investments.⁴³ The percentage that is reinvested will of course vary depending on market conditions, but for one bank was always at least 50 per cent.⁴⁴ The impact of individual investors in government securities can be seen, therefore, as being similar in some respects to their impact as depositors – their presence and consistency encourages the banks to make somewhat longer term investments, improving the ability of the government to raise finance. Lastly, individual investors should not be seen as necessarily confined to short maturities. In Lebanon, as will be discussed further below, individual investors enthusiastically bought a security with a 10 year maturity. In Turkey, lower interest rates and relative economic stability had started, at the time of interviewing in December 2005, to encourage (at this point, slightly) longer maturity investment.⁴⁵ In Brazil, by September 2005 a substantial fall in interest rates had not yet happened, but interviewees expected such a movement to longer maturity investment (through mutual fund investment), particularly once short term interest rates fell below 10 per cent.

⁴¹ Treasurer, foreign-owned bank, Turkey, interviewed 7 December 2005; Director General, Turkish central bank, interviewed 1 December 2005; Division Head, state-owned Turkish bank, interviewed 8 December 2005; Department Head, Turkish Treasury, interviewed 1 December 2005.

⁴² Division Head, state-owned Turkish bank, interviewed 8 December 2005; Manager, Turkish bank, interviewed 6 December 2005; Department Head, Turkish Treasury, interviewed 1 December 2005.

⁴³ '[G]enerally short term issuance goes to retail, but they have a tendency to keep in short dated maturities although they keep rolling their investments all the time' (Trader of Turkish domestic bonds, investment bank, London, interviewed 22 June 2005. The interviewee has previously worked at a Turkish bank).

⁴⁴ Division Head, state-owned Turkish bank, interviewed 8 December 2005.

⁴⁵ Vice President, Turkish investment company, interviewed 6 December 2005; Division Head, state-owned Turkish bank, interviewed 8 December 2005.

A 'buy and hold' investment strategy amongst individual investors has also included a reluctance to take losses, 'loss realization aversion' or a 'disposition effect' (see, for example, Odean 1998; Barber and Odean 1999; Shapira and Venezia 2000; Rangelova 2001; Dhar and Zhu undated). Investors would prefer to hold on to investments that are showing losses at prevailing prices, rather than sell them and crystallise the loss. If as true for individual investors in emerging bond markets as in developed world equity markets (and also noted by international interviewees regarding Lebanese and Turkish banks), this aversion is a potential positive in a period of economic uncertainty, when bond prices are clearly likely to fall. Loss realisation aversion is a well-recorded behavioural trait of all traders, to be managed in the Chicago futures pit (Zaloom 2006: 131) or on an investment bank trading floor.⁴⁶ It is, however, seen as more prevalent amongst individual, rather than professional, investors. In the case of individuals buying government bonds, it is reinforced by how individuals look at their investments. Individuals look at their holdings of bonds largely as a substitute for bank deposits, and as a result look to hold a bond until maturity (when, absent a default, they will receive their principal) and receive their interest until that date. This mirrors their expectation of bank deposits, making short-term market movements less material (see chapter 2 regarding banks' investment books, which invest in the same way).

A 'buy and hold' strategy, combined with a strategy of frequent reinvestment at maturity, serves to enhance the autonomy of governments from the policy preferences of international investors. Individual investment is, in reality, likely to be of a longer timeframe than it might appear from the short-term nature of the initial security bought (see Montes and Ravalo 1995: 145 for the same observation regarding the rollover of short term loans in the Philippines). Individuals are less likely to sell their bonds when prices are low, as they are unwilling to experience a loss. Both these traits serve to make it easier for a government to raise finance.

⁴⁶ Head of Emerging Market Trading, investment bank, London, interviewed 17 October 2005.

Individuals Have a More Positive Attitude to Government Creditworthiness

Individual investors have a high confidence in the creditworthiness of Lebanon and Turkey. This confidence has been shown in a willingness to invest at times of uncertainty, therefore doing more than merely holding their investments as a result of the disposition effect. Individual investors provide an alternative source of finance for governments at times when other investors, including on occasions the domestic banks, are more cautious. Even outside periods of uncertainty or crisis, this has a significant impact on investment decisions, to the benefit of government financing. In Brazil, government debt is the 'riskless' asset against which all other investments are compared; with yields, through investment in short maturity government bonds directly or via mutual funds, so high, the attitude to alternative investments can be summed up as 'why bother?'⁴⁷ In Lebanon, the situation is slightly more nuanced, in that investors may have greater confidence in the banks than in the government, with no depositor losing money as the result of a bank collapse since 1966.⁴⁸ In Turkey, the two appear largely interchangeable, at least as far as the largest banks are concerned, with individuals willing to hold either deposits or government securities, whichever has the higher return. Despite these differences between the case study countries, in all three a move from government debt to other alternative investments is likely to require a potential increase in return, rather than being driven by a desire to diversify risk.

The confidence in the creditworthiness of the government is linked to the extent to which individual investors are backward looking in their investment decisions (Gooding 1976; Shiller 1988; Bange 2000), although this evidence mainly focuses on individual investors buying stocks which have already risen in price. As Gooding (1976: 32)

⁴⁷ 'If you're receiving a real interest rate that is above 11 per cent why bother taking longer maturities, why bother taking whatever other sorts of risks. Actually, you end up only getting volatility and expected returns actually tend to be lower than the real risk free rate in Brazil' (Head of Products and Services, foreign bank's wealth management division, interviewed 30 August 2006). Also senior official, Banco Central do Brasil, interviewed 5 September 2006; Head of Trading, foreign-owned bank, Brazil, interviewed 4 September 2006.

⁴⁸ Senior official, Lebanese bank, interviewed 8 September 2005.

observes, there is evidence that “individual investors” risk perceptions correlate very closely with *ex post* measures of risk’. While this does not explain why the impact of negative events such as Lebanon’s civil war currency weakness or Brazil’s inflation experience are so long-lasting, it is worth noting Lewellen *et al.*’s (1977) analysis of the impact of age on investment decision-making, which suggests that any learning effect can manifest itself over a lifetime of investing. Muñoz, considering Italy, demonstrates the persistence of asset allocation preferences amongst individual investors, and concludes that ‘households develop a taste for the assets they hold and do not change their portfolios very frequently’ (2006: 30), an observation also made regarding individuals in Turkey.⁴⁹ Looking at the United States, Ameriks and Zeldes (2004) find that almost half their sample had not changed their asset allocation in nine years.⁵⁰ It could be argued that individual investors lack the capacity to incur the transaction costs necessary to make the changes in an established investment style, particularly in a less financialised capital market where alternative ways to take risk are less easily accessed, unless the consequences of inactivity are potentially serious. Loyalty is therefore again linked to the high costs of exit.

There is nevertheless evidence that individuals will use opportunities to manage their risk when the option is available to them. The very wealthy in a volatile environment such as Lebanon will often keep a proportion of their assets offshore as a matter of course.⁵¹ In Turkey, there has been capital flight during crises.⁵² In the lead up to the 2001 crisis in Turkey, individuals did sell their domestic government bonds, and reacted more quickly than foreign investors,⁵³ mirroring the behaviour of Mexican equity market investors recorded by Frankel and Schmukler (1998). Interviewees in both Lebanon and Turkey note the high level of knowledge of individual depositors and

⁴⁹ See also Manager, Turkish bank, interviewed 6 December 2005.

⁵⁰ These conclusions are a variance with the standard models of portfolio allocation, Samuelson (1969), and Merton (1969 and 1971), which model frequent portfolio change.

⁵¹ Director, foreign bank, Lebanon, interviewed 5 September 2005; Assistant General Manager, Lebanese bank, interviewed 12 September 2005; Treasury Manager, Lebanese bank, interviewed 9 September 2005.

⁵² Department Head, Turkish Treasury, interviewed 30 November 2005.

⁵³ Executive Vice President, Turkish bank, interviewed 7 December 2005.

investors regarding those factors that will influence market performance.⁵⁴ There remain interesting areas for further research regarding whether individual investors in emerging developing countries are more knowledgeable regarding their own country's financial markets than individuals in more developed and stable countries, in addition to the extent of individual investment in different countries. In Turkey, substantial funds have remained outside the banking system, held in assets such as gold⁵⁵ or 'mattress money': 'it is conceivable that...they are as high as the formal savings' (World Bank 2003: 19). In Brazil, capital flight was 'insignificant' from 1974-1982 (Cuddington 1986: 3; also Mahon 1996: 64 for 1980-1982⁵⁶), relative to other large Latin American economies, but this was because of the availability from 1964 of government securities providing protection from both inflation and currency risk.⁵⁷ During the severe market weakness of 2002, wealthy Brazilian individuals responded by purchasing 'real' assets to protect themselves, as well as moving into US dollars.⁵⁸ The continued holding of dollar assets, particularly deposits, is also risk-reducing diversification, which comes at the cost of lower returns if the domestic currency does not depreciate, as the Lebanese pound has not since 1993. Baer (2001: 193) argues the 1980s saw a decline in public confidence that the Brazilian government could service the debt, leading to higher interest rates and shorter maturities (see also Macado and Barbosa 1997, who suggest 'chaos' in the economy at the time of Collor's inauguration as Brazilian president in 1990). This suggests individuals' confidence in their government's creditworthiness is in no sense

⁵⁴ '[P]eople are aware of the...economic news, even the taxi driver would know how much dollar would cost in TL right now. They're very aware, Turkish people. The reason, of course, [is] we have experienced a lot of crisis' (Executive Vice President, Turkish bank, interviewed 7 December 2005). The awareness described here is regarding the exchange rate, which might result in moving between local currency and foreign currency bank deposits.

⁵⁵ In Brazil, the trading of gold futures as currency, and therefore inflation, hedge was a significant contributor to the development of the BM&F, the futures exchange (senior official, BM&F, interviewed 1 September 2006).

⁵⁶ Mahon's explanation for low levels of capital flight, however, is that it resulted from a policy favouring a competitive exchange rate.

⁵⁷ Former Deputy Governor, Banco Central do Brasil, interviewed 30 August 2006; Head of Fund Management, Brazilian bank, interviewed 30 August 2006; former Governor, Banco Central do Brasil, interviewed 29 August 2006. In practice, the government was able to have the inflation index for government bonds lag the general inflation index (Baer 2001: 138; Macado and Barbosa 1997: 17), making the inflation-linked bonds an imperfect hedge.

⁵⁸ 'I had private clients buying boats, buying houses, buying motor vehicles, buying planes' (Head of Products and Services, foreign bank's wealth management division, Brazil, interviewed 30 August 2006).

infinite (although note that Brazil, unlike Lebanon and Turkey, has a record of default). The apparently-strenuous efforts of depositors in Lebanon to break their deposits early immediately after the assassination of Rafik Hariri, described in the previous chapter, suggests a similar limit was (very temporarily) reached there. The argument being made here, however, is that the view of individuals on the creditworthiness of the government is more positive than that of other market actors.

Nor should such backward-looking investment be seen as necessarily positive for governments. Brazilian individual investors remain focused on very short term, inflation-protected investments, because of the experience of very high inflation, despite the Real Plan having effectively controlled inflation since 1994 (see chapter 4; for the history of inflation-protected investment, see Baer 2001: 159). Similar, far backward-looking behaviour can be seen in Lebanon, with a lack of confidence in the currency because of the experience during the civil war,⁵⁹ despite stability since 1993. In Turkey, investors do not have to look far back in history to see an incentive to hold US dollar assets (although recent stability has encouraged a move to Turkish lira), and are likely to move to dollars at the first sign of instability.

This backward-looking investment is, however, generally positive for the attitude of citizens to the creditworthiness of any government that has not defaulted, and has a generally positive influence on the government's ability to raise financing. In both Lebanon and Turkey, interviewees expressed almost total confidence that their respective governments would not default, because, it was argued, they had never done so (in Turkey's case, '[we] even...paid our Ottoman liabilities'⁶⁰). This is in marked contrast to international investors. Their expectations of a default within 5 years was anywhere from 10 (although this interviewee felt that based on 'economic fundamentals'

⁵⁹ Senior Economic Officer, Ministry of Finance, interviewed 7 September 2005; Assistant General Manager, Lebanese bank, interviewed 12 September 2005; senior official, Lebanese bank, interviewed 8 September 2005; Treasury Manager, Lebanese bank, interviewed 9 September 2005.

⁶⁰ Executive Vice President, Turkish bank, interviewed 7 December 2005. Also General Manager, Turkish investment company, interviewed 8 December 2005.

the figure should be 30 – 40 per cent⁶¹) to 80 per cent in the case of Lebanon and ‘practically zero’⁶² – albeit by a Turkish expatriot – to 30 per cent for Turkey. These are countries with a low credit rating, but are not expected to default by their citizens, largely because they have not already defaulted. This is despite the fact that the international rating agencies are signalling a significant possibility in the future, a view with which international investors largely agree. However, once individuals have experienced a period of instability, such as the very high inflation in Brazil or the severe currency weakness in Lebanon and Turkey,⁶³ it takes a long period for them to cease to act in expectation of a repeat. Again, the contrast with international institutional investors appears stark. The experience of Argentina after the 2001 default suggests international investors will quickly change their view (see Datz 2007). In general, therefore, although individuals will, when the opportunity is there (as it frequently is for the wealthiest), act to protect themselves, they ‘are concerned about the market risk, not the default risk at all’.⁶⁴ Such an attitude can be seen in moving to shorter maturity bonds at times of crisis, as in Brazil, and in moving to dollar deposits, rather than exiting entirely, in Lebanon and Turkey.

This confidence in the creditworthiness of the sovereign can be particularly important at times of economic uncertainty or crisis. To illustrate this, I return to the experience of Lebanon after Rafik Hariri’s assassination and the 2001 economic crisis in Turkey. In both cases, the activities of individual investors were significant. As discussed in chapter 2, after Hariri’s assassination, the Banque du Liban suffered a fall in foreign currency reserves. In order to replenish these reserves, the central bank in April 2005 issued a 10 year Certificate of Deposit (CD), a tradable security similar to a bond (the central bank issued a CD only because at the time, for technical reasons the Ministry of Finance was

⁶¹ Fund manager, London, interviewed 21 October 2005.

⁶² Research analyst, London, interviewed 16 February 2005.

⁶³ ‘[P]eople have in their minds that hard currency is a very safe investment in the long term. And it is quite difficult to change that’ (Division Head, state-owned Turkish bank, interviewed 8 December 2005).

⁶⁴ Division Head, state-owned Turkish bank, interviewed 8 December 2005; also General Manager, Turkish investment company, interviewed 6 December 2005.

unable to issue a Eurobond⁶⁵). This borrowing was launched at a period of considerable uncertainty (although the worst appeared at the time to be past), but sold in substantial volumes to individual investors. This contributed to an issue size of US\$2 billion, more than the central bank had expected.⁶⁶ The amount was equal to the amount withdrawn from the country, and therefore equal also to the fall in gross foreign exchange reserves, after the assassination. The reason was the high return compared to the alternative investment for these individuals: bank deposits. '[W]e had unbelievable demand by the retail [i.e., individual investors], because it's paying...10 per cent coupon, yield 10½, you would have everybody rushing to buy it...[W]e had demand in 50, 60, 70 million dollars, probably, if not more'.⁶⁷ At the time, bank deposits were paying around 3.5 – 4.5 per cent.⁶⁸ Critics claim the interest rate was higher than necessary,⁶⁹ and the yield was certainly high relative to the outstanding Eurobonds, which had not fallen in price as much as might be expected (see chapter 2). However, it is important to place this borrowing in perspective. A country rated a low B3/B- (by Moody's and Standard & Poor's respectively), and had which had just been downgraded by Moody's,⁷⁰ was able to borrow US\$2 billion at a time of economic and political uncertainty (albeit also some optimism after the Syrian withdrawal) at an acceptable interest rate. It was able to do so in part because of the confidence of individual investors that their country would not default.

A similar situation occurred in Turkey, where the actions of individual investors caught even the domestic banks by surprise. The focus of interviewees' comments was the 2001

⁶⁵ Senior official, Banque du Liban, interviewed 8 September 2005. The assassination of Hariri temporarily paralysed the normal workings of government (see Blanford 2006), so that the approvals required for a government issue could not be obtained.

⁶⁶ Senior official, Banque du Liban, interviewed 8 September 2005.

⁶⁷ Head of Treasury and Capital Markets, Lebanese bank, interviewed 9 September 2005. This is the same bank which more ordinarily sells US\$10 – 20 million of an issue to individual investors. Also Executive Adviser to the Chairman, Lebanese bank, interviewed 8 September 2005; senior official, Banque du Liban, interviewed 8 September 2005.

⁶⁸ Head of Treasury and Capital Markets, Lebanese bank, interviewed 9 September 2005.

⁶⁹ '[P]eople...at 7 per cent would have been extremely satisfied, and what happened is that immediately after the issue, the price of the CDs went up' (former Minister of Finance, interviewed 6 September 2005).

⁷⁰ On 24 March 2005 (www.moody.com).

financial crisis, but it was also observed that the same had happened in 1994.⁷¹ On both occasions, there were fears regarding the government's ability to raise financing, and on both occasions it was individual investors who were attracted by the high interest rates (nominal, and importantly in a high inflation country, real), and who ensured successful auctions.⁷² The central point is that, in these incidents, the individual investors were prepared to act in a way that even the domestic banks were not. The banks, initially unprepared to enter the auctions, to finance the government, then followed their individual investors, encouraged that the volume of individual investment would result in a successful auction rather than any belief that these individual investors possessed superior information. Individual investors 'supported the Treasury more than the banks did'.⁷³ The very high real interest rates involved in attracting individuals, 50 – 70 per cent, would not be sustainable, but the success of these auctions ensured the government was able to avert an even more costly crisis. After 2001, as the situation recovered, retail investors continued to be dominant until the Iraq invasion.⁷⁴ An example, from the period in 2003 when the Turkish parliament rejected the United States' request to use Turkey for the invasion of Iraq, is worth quoting at length:

[T]hose guys [foreign investors] were out there saying, they're going to default in three months, we've done the numbers. You know they're all short, blah blah... so here's this big speculative attack.... They're short of currency, they're short Eurobonds... they think this is like the big one, and they're [Turkey is] gonna go... Now the [Turkish] banks... are sitting there going pffff... don't think Turkey will really default and hope they don't because we have all this [exposure]... but they're looking... terrified at the foreigner and looking to protect themselves.... But the guy on the street thinks,... because at this point obviously yields are backed up, whatever, 700 basis points... and real interest rates are like 20 per cent or something, and they're sitting there going these are

⁷¹ Manager, Turkish bank, interviewed 6 December 2005.

⁷² '[T]he government auctioned 2 auctions with a very high real return. I think the one that they auctioned in 1994 was around 200 per cent interest, nominal interest but yielded around 50 or 70 per cent real interest. And you know we bankers did those calculations, but there was an enormous bidding [by] the retail people. They sensed it... this is unbelievable... Maybe then you talk to them on the phone and they wouldn't give you a very clear explanation of why they bid on the auction but they say 'Hey, this is an opportunity'' (Executive Vice President, Turkish Bank, interviewed 7 December 2005).

⁷³ 'We followed the retail investors in those auctions.... They supported the Treasury more than the banks did' (Executive Vice President, Turkish bank, interviewed 7 December 2005).

⁷⁴ Head of Treasury, Turkish bank, interviewed 7 December 2005.

some pretty good yields and essentially...the guy on the street piled in....They directly bought the auctions...[I]t also helped that the government...rejected the troops and within that weekend they passed the budget...and the guy on the street basically piled into the bonds and all of a sudden the thing really turned, because here is a case of a very very high interest rate currency, shorting is very very painful,⁷⁵ and you got this retail wall of money coming in, selling dollar lira and buying T-bills, they [the international investors with short positions] had no chance. So it reversed very quickly'.⁷⁶

This is an example of a situation where a crisis could have occurred but did not.

Government policy decisions are important to these outcomes, but also of central importance are the potential investors in government debt, and their investment attitudes. The involvement of individuals as direct investors is a positive for the government's ability to raise financing and to avoid or manage financial crisis.⁷⁷

Individuals in most countries, developed or otherwise, if they can have confidence in the banking system, hold bank deposits as their main, or one of their main, liquid financial assets. It is therefore doubtful whether it is possible to simply see government debt as the 'risk free' choice for investment, with other investments only acceptable if they offer a yield commensurate with the increased risk. Certainly, this has not been the case in the countries considered here. The incentive to buy government debt in Brazil (in this case through mutual funds) did include concerns regarding the creditworthiness of the banks,⁷⁸ but in both Lebanon and Turkey confidence in the banks has generally been high. In Turkey, for smaller banks this confidence was thanks to deposit insurance introduced in 1994 (Altunışık and Tür 2005: 84), but now reduced in scope; there has always been high confidence in the largest private banks. In deciding whether to buy

⁷⁵ Any short position costs the trader the interest rate of the bonds or currency sold minus the interest earned on the proceeds of the short sale. Therefore, a short position in a relatively high-yielding bond or currency will lose money if there is no movement in the market. A similar situation has prevailed in Brazil.

⁷⁶ Research Analyst, London, interviewed 23 June 2005.

⁷⁷ In partial contrast, Kim and Wei (1999), looking at the Korean equity market, conclude that, while individual investors in general herd more than institutional, resident individual investors herd less than non-resident investors, institutional or individual.

⁷⁸ Head of Fund Management, Brazilian (bank-owned) fund management company, interviewed 30 August 2006.

government bonds, therefore, the comparison for investors in these countries is mainly the return they can achieve on bank deposits,⁷⁹ which would ordinarily be amongst the lowest-yielding investments. If the banks are competing for deposits, however, and therefore offering high rates, demand for government securities can be reduced. This occurred in Turkey in 2005.⁸⁰ What is clear, however, is that the comparison is not with investment opportunities outside the country, and '[t]hey wouldn't much care if there is a global crisis or if there is a current account deficit'.⁸¹ In considering the difference in attitudes of international investors to investment in emerging markets, Mosley (2003) shows that they focus on a far wider range of issues than when investing in developed countries. In contrast, it would appear that individuals investing in their own countries are particularly narrow in their focus.

Conclusion

This chapter has discussed individuals investing in their own government's bonds. Rather than focusing on regulation, it has concentrated on the inherent nature of individuals as investors, in particular the transaction costs they face. These transaction costs (especially, but not restricted to, information costs) result in a more marked home bias on investments, and a willingness to accept a less diversified portfolio than other investors, including the commercial banks with whom, as an alternative, individuals place deposits. Diversification is largely driven by the opportunity for increased yield, rather than reduced risk, and in high-yielding emerging markets further increased yield is less easy to find. Individual investors are 'buy and hold' in their behaviour, less likely to sell if prices have fallen, and much of their investment, although short-term, is subsequently reinvested. Investment strategies show limited change. Perhaps most

⁷⁹ Head of Treasury and Capital Markets, Lebanese bank, interviewed 9 September 2005; Director, foreign-owned bank, Lebanon, interviewed 5 September 2005; Deputy General Manager, Lebanese bank, interviewed 3 September 2005; senior official, Banque du Liban, interviewed 5 September 2005; Division Head, state-owned Turkish bank, interviewed 8 December 2005; Department Head, Turkish Treasury, interviewed 1 December 2005.

⁸⁰ Economist, foreign bank, Turkey, interviewed 5 December 2005; Head of Treasury, Turkish bank, interviewed 7 December 2005.

⁸¹ Executive Vice President, Turkish bank, interviewed 7 December 2005.

significantly, individual investors demonstrate a high degree of confidence in the creditworthiness of their own government. While this confidence is finite, it can, as demonstrated above, mean that individuals, if given the yield inducement to do so, will support government financing at times of economic uncertainty, including when other market actors will not. Individual investors also appear less concerned with fundamental indicators of financial performance and with international economic influences. For all these reasons, it is argued in this thesis that the involvement of individuals as direct investors in government debt represents an increase in the autonomy of an emerging market government from the preferences of international market actors, even relative to the involvement of domestic banks.

The analysis in this chapter has concentrated in particular on the high transaction costs of exit and the loyalty engendered by such exit costs. This loyalty is in line with Hirschman's first and more widely recognised conception of loyalty. It is highly unlikely that an individual investor will be able to consider him-/herself able to be a 'quality-maker', and so Hirschman's second conception is also highly unlikely to apply. I recognise the potential for an additional loyalty based upon patriotic feelings towards the individual investors' home country, but the difficulties in quantifying such feelings, and in identifying differences in this regard between the case study countries (see chapter 1), mean this patriotic loyalty has not been included within the analysis. It should be noted, however, that to the extent such a loyalty does exist as a material influence on individual investor decisions, it serves to reduce financialisation, the trading of risks other than one's own government, and increase government policy autonomy. A more constructivist approach to loyalty, therefore, does not undermine the underlying argument in this chapter.

Increased government autonomy is likely to be reduced as alternative investments are available to individual investors. Increased ability to take risks on investments other than government securities is a result of greater financialisation. This reduces the transaction costs of diversification. This can be the result of internationalisation, as demonstrated in

Lebanon, where international banks offer products the domestic banks feel obliged to match.⁸² However, there is no reason that internationalisation, in the sense of a greater involvement of international financial market actors, is necessary for this financialisation. The development of alternative assets for individuals, such as equity investments or corporate bonds are examples of financialisation which may be driven domestically, but which will also divert individual funds from direct investment in government securities, and in bank deposits which will then, in part, be reinvested in government securities. For the wealthiest individuals in the case study countries, this is a process which has begun, and further financialisation will involve these alternatives being increasingly offered to less wealthy individuals, as is the case in developed countries generally (for developments in the United States in the 1970s, see Krippner 2007). As financialisation develops, as a result of possibly parallel processes of innovation, domestic liberalisation and internationalisation, the alternatives available to individual investors increase, and the potential amounts of investment in government securities declines (unless government bonds are made more attractive, most obviously through higher yields).

The evidence from the developed country equity markets suggests that this financialisation will not remove the distinction between institutional and individual investors, but final investment decisions may increasingly once again be taken by professional intermediaries in a process of reintermediation of individual savings (noted in the United States by Lease *et al.* 1974; Lewellen *et al.* 1977; Schlarbaum *et al.* 1978). This reintermediation involves institutional fund managers of various forms, for example pension funds, mutual funds and hedge funds. It is these institutional investors that the following two chapters will consider.

⁸² Deputy General Manager, Lebanese bank, interviewed 3 September 2005.

Chapter 4

Domestic Institutional Investors

Introduction

In the previous two chapters, I have concentrated on two types of investors, banks and individuals, whose importance as buyers of government bonds markets has not been widely recognised. I move now to consider investors who would commonly be seen as the core of financial market activities: institutional investors – pension funds, mutual funds and hedge funds.¹ However, the focus in this chapter remains with domestic investors in the case study countries, rather than on international investors.

The framework for the analysis continues to be Hirschman's (1970) discussion of loyalty. Many of the institutional investors considered here fulfil some of the criteria for Hirschman's second conception of loyalty. Most importantly, in the case of many pension and mutual funds, because the majority of their portfolios are government bonds, they are likely to care about deterioration whether or not they continue to buy bonds – because full exit is impossible. However, while a small number of institutional investors in Brazil may be able to be 'quality-makers', it is not generally the case. Whereas a small group of commercial banks in Lebanon or Turkey can (or think they can) have an influence on the market, institutional investors, as will be seen, are far greater in number, smaller in size and disparate in investment objectives. It will nevertheless continue to be argued investors are subject to more than 'enforced loyalty'.

¹ Institutional investors would also include insurance companies. These investors are not specifically considered here, as they are a small part of the government bond market in Brazil, Lebanon and Turkey. However, many of their characteristics are similar to those of pension funds (see Davis and Steil 2001). In Brazil, life insurance companies and certain pension funds are represented in discussions with the Ministry of Finance by the same association (senior official, Ministry of Finance, Brazil, interviewed 6 September 2006). Bodie *et al.* (2005) list five different institutional investor types (excluding banks): mutual funds, pension funds, endowment funds, life and non-life insurance companies.

Regulation (and government choices regarding regulation) remains important in the consideration of domestic institutional investors, and it is recognised that a central difference between domestic and international institutional investors lies in a government's far greater ability to regulate the former. However, as has been discussed elsewhere, loyalty linked to the cost of exit is not solely the result of regulation; it is also linked to the nature of the institutions themselves.

A number of separate, but connected, arguments will be presented in this chapter, all analysing the influence of different investor types, and changes within the types, on the position of a government on the 'autonomy curve' that is the central focus of this thesis. The arguments regarding institutional investors in general return to many of the areas covered in the previous chapters. The new arguments made here are as follows:

1. On pension funds

The establishment of pension funds, most commonly replacing a state-funded system, while an increase in financialisation, initially represents an increase also in government policy autonomy. As pension funds increase in size, have restrictions on investment reduced and as the financial markets in which they operate increasingly offer wider investment options, government policy autonomy decreases. Nevertheless, the nature of pension fund liabilities, long term and in the domestic currency, means they maintain a higher degree of loyalty to the government debt market than the other institutional investors considered.

2. On mutual funds

Mutual funds, similarly, can (and in Brazil and Turkey, do) initially increase the ability of the government to raise financing, and therefore policy autonomy, relative to bank financing. The first mutual funds are mainly 'money market funds', direct competitors to bank deposits, and invest predominantly in government securities. The initial

development of these funds may serve to increase the government's ability to raise financing, as longer maturity government debt is purchased. This longer term investment is mainly a reaction to falling interest rates, but government policy (such as taxation) also has an influence. Any subsequent development of mutual funds, through similar processes to that of pension funds, also increases the diversity of investment, reducing the proportion investing in government securities, and therefore reduces policy autonomy.

3. On hedge funds

The increasing involvement of hedge funds, even if they are domestic, increases the influence of international investor preferences on government finance, and therefore policy. As hedge funds exploit, in a variety of strategies, an increased ability to trade risk, government policy autonomy decreases. The ability of hedge funds to borrow to increase their investments (to leverage) means any funds they manage are disproportionately influential. Most importantly, hedge funds' ability to short – to sell securities they do not own – gives them the ability to express 'disloyalty' (see chapter 2 on bank proprietary trading desks). The result is that hedge funds are not loyal investors. If unconstrained by regulation or investor requirements, they represent the (current) extreme of financialisation and the greatest constraint on government policy autonomy. Constraints on hedge funds still exist in Brazil, the only case study country where hedge funds are active, but they are reducing.

Chapter Structure

This chapter will first discuss the involvement of institutional investors in financing the governments of the case study countries. As will be shown, this involvement is substantial in Brazil, particularly mutual funds but also hedge funds, nascent in Turkey, and almost non-existent in Lebanon. The chapter will secondly consider issues surrounding institutional investors in general. Many of these issues have been introduced

in previous chapters, and the aim will be to provide a contrast between institutional investors in general and banks and individual investors. The intention is to consider the implications for government financing of the increased institutionalisation of investment in government bonds. A number of the points raised in this section are also relevant to chapter 5, on international investors. The third section of the chapter will then look at the differences between the three institutional investor types analysed, again with a view to considering the implications for government financing. This section will also consider changes in the investor types discussed, as a result of the increased financialisation of the investors themselves. This section will demonstrate how, as with domestic banks, it is changes in the activities of the investor types analysed, in addition to the emergence and increasing importance of new investor types, that prompts changes in the government bond market. The chapter must, however, first deal with questions regarding the definition of different investor types.

Definitions and Their Problems

The aggregation involved in this study of investors results in a number of problems. The first is simply of definition; all investors, other than individuals, are institutions. This study adopts the usual bond market parlance in considering banks (though clearly institutions) as distinct from institutional investors. Within the category of institutional investor used here, a pension fund is easily understood, but the definitions of mutual fund and hedge fund are not entirely clear. Under most definitions, a hedge fund is a type of mutual fund. Further, there is the problem of one type of institution investing in another. It is common, for example, for pension funds to invest in mutual funds, and increasingly in hedge funds. This is the case in Brazil, where, in 2004, 62 per cent of pension fund assets were invested in fixed income mutual and hedge funds, compared to a low 12 per cent invested directly in government securities (Borensztein *et al.* 2007: 157, citing Leal and Lustosa 2004; Medici 2004: 8 gives 2002 figures). In the United States, similarly, 30 per cent of mutual fund assets are held by other financial institutions, mainly pension funds (Davis and Steil 2001: 17). Lastly, even aggregation

at the level of a single institution is unsatisfactory: each fund management company runs many different funds, with different investment mandates involving geography, financial instrument and/or investment style. What are generally seen as hedge fund companies, for example, have been establishing funds which would more accurately be seen as mutual funds under the definitions discussed below, and mutual fund companies are also attempting to encroach on the hedge fund business. Crockett (2007: 22) notes how already, in developed countries, 'boundaries between [hedge funds] and other types of collective investment vehicle have become blurred', and concludes (*ibid.*: 20), because of these problems, that 'hedge funds should not be regarded as a single asset class, but rather as a specialized vehicle for gaining access to the risks and rewards of more fundamental asset classes' (see also Eichengreen and Mathieson 1998b: 4). Despite these difficulties, which can only be acknowledged rather than mitigated, an analysis which concentrates on investor type appears appropriate. The distinction between mutual fund and hedge fund will be clarified below. The process by which, for example, pension funds invest in hedge funds (Crockett 2007: 23; Chadha and Jansen 1998: 35) represents an increasing influence for the hedge fund style of investment, with consequences which will be explored further below. Such a process, like the multiple investment mandates within a single firm, presents difficulties in research, but does not change the conclusions of this study.

Pension funds, as suggested above, are most easily defined. This is long-term investment aimed at providing an individual with an income upon retirement. Pension funds can generally be divided into two broad categories. 'Defined benefit' pensions guarantee the contributor a pension amount on retirement (frequently linked in some way to the individual's pre-retirement earnings). The risk of any investment shortfall (up to the bankruptcy of the company providing the pension guarantee) is taken by the pension manager or the pension recipient's employer. 'Defined contribution' pensions make no guarantee as to the final pension, which is based on the performance of the fund in which an individual or his/her employer invests. They 'collect, pool and invest funds contributed by sponsors and beneficiaries to provide for the future pension entitlements

of beneficiaries' (Davis and Steil 2001: 15), and so have long-term (with, for beneficiaries approaching retirement, some short-term) liabilities against which they must accumulate assets. Importantly when considering their role as investors in government debt, for their individual investors, pension fund assets are effectively illiquid (Davis and Steil 2001: 288). In Turkey, a defined benefit, government run system has been reformed since 1999 (see World Bank 2003: 33 for details) and moved to a system of defined contributions, with investments made into what are called 'pension mutual funds'. Brazil's pension system is of long standing (the first pension law dates from 1923), with now four main schemes (Medici 2004). There are separate 'pay as you go'² pension systems for private and public sector workers, a non-contributory pension for those in the informal sector or disabled, etc., and optional, privately managed complementary pensions (complementing the other types). Much of the attention in Brazil since at least 1998 has been focused on reform of the 'pay as you go' pension schemes, particularly the privileged position of civil servants, but the focus here will be the complementary pension funds.

Mutual funds 'are simply vehicles for the pooling of assets for investment purposes' (Davis and Steil 2001: 16; see also for a discussion of different types of mutual fund). Such a broad definition clearly is not particularly helpful in differentiating mutual funds from other institutional investors, including pension funds and hedge funds. Pension funds can be distinguished by their purpose: to provide pensions. Mutual funds, in contrast, offer short-term liquidity. 'Closed-end' funds provide liquidity to investors through trading the shares of the fund itself. 'Open-ended' funds allow investors to redeem the fund's underlying assets (*ibid.*: 17). Both types of mutual fund seek to maximise returns within their investment mandate. Although that mandate may be for long-term capital growth, mutual funds should best be seen as shorter-term in their investment than pension funds. The distinction between hedge funds and mutual funds lies, technically, in the fact that when they were first established, hedge funds were structured to avoid the need to comply with U.S. restrictions on short selling and

² Payments made to the scheme fund current pension payments, not the future pensions of the payees.

leverage (Ubide 2006; Chadha and Jansen 1998: 27). Generally speaking, hedge funds have far greater latitude in their investment activity, but the ability to short and the ability to employ substantial leverage³ – to borrow to increase investments, and therefore risk and return (Basel Committee on Banking Supervision 1999) – are the capacities that distinguish hedge funds from mutual funds in this study (see Davis and Steil 2001: 64; Fung and Hsieh 1997 show the differences between hedge and mutual fund investment strategies). Restrictions on solicitation by, and investor access to, hedge funds are less relevant to the difference, but increased individual investor access to hedge funds, for example through ‘funds of funds’ (Crockett 2007: 21), is an example of increased financialisation.

How Much Government Debt do Institutional Investors Own?

Across the emerging markets generally, in 2005 domestic institutional investors owned almost a third of central government debt (IMF 2006f). Unfortunately, however, it is not always easy to distinguish from the data available ownership by different types of institutional investor, partly because of the definitional difficulties outlined above. In Lebanon, the National Social Security Fund held only just over US\$1 billion equivalent of Treasury bills at the end of 2004 (IMF2006e: 8), 8 per cent of the outstanding securities. The NSSF’s ownership of Treasury bills was on a declining trend. The political controversy surrounding the NSSF, including regarding the opacity of its accounts (*Daily Star*, 15 March 2007), makes analysis difficult, and non-governmental institutions are not significant in the government debt market. Institutional investors in Lebanon will therefore not be considered in this chapter.

In Turkey, the development of institutional investors of all three kinds is at an early stage. Regulatory approval for hedge funds was given only in September 2006 (Capital Markets Board 2006), and a Treasury official was unaware of any domestic hedge funds

³ Some mutual funds can borrow (Davis and Steil 2001: 65) but the difference is hedge funds’ high leverage.

active in the government bond market.⁴ In the domestic government bond market, as shown in Appendix B, Table 4, resident mutual funds (which include ‘pension mutual funds’) owned, as of 27 October 2006, only 5.7 per cent of ‘market’ securities. This is clearly as yet a very small percentage, but reflects the recent establishment of these institutions. Turkish government regulations for the private pension system were published in February 2002 (World Bank 2003: 38). The authorities’ expectation is of substantial growth in the near term, to pension fund assets of US\$10 billion in five years from 2005 (still less than the current mutual fund assets) and twice that in ten years,⁵ and the World Bank (2003: 39) is slightly more optimistic. Growth in mutual funds in general is also strong, and mutual fund companies expect further growth, despite an ending of the tax advantage of mutual funds at the end of 2005.⁶ Institutional investors’ impact on the domestic government bond market in Turkey is therefore a subject principally for the future. With regard to Turkish international bonds, institutional investors, measured by the amount held in custody on their behalf by the Turkish banks, held bonds with a maximum value of US\$938 million (as of 22 December 2006).⁷ Individuals, by way of comparison, owned US\$2.48 billion. So, again, institutional investors are not a significant force.

In contrast, institutional investors predominate in Brazil. At the end of September 2006, mutual funds owned half of all domestic government bonds, more than banks. This is a broad definition of mutual funds, including the complementary pension funds and hedge funds. As noted above, pension funds hold relatively few government securities directly (only 12 per cent of assets as of 2004), but hold most of their total investment in government bonds through investment in mutual and hedge funds. An estimation of institutional investor holdings of Brazilian international bonds is unlikely to be accurate

⁴ Department Head, Turkish Treasury, follow-up telephone interview, 21 February 2007.

⁵ Department Head, Turkish Treasury, interviewed 30 November 2005.

⁶ Manager, Research, Turkish investment company, interviewed 6 December 2005.

⁷ Figures provided by Turkish Treasury official, e mail communication, 8 January 2007, based on BRSA figures. Over US\$580 million is held by ‘other legal entities’ and ‘other financial institutions’, which could include investment banks and companies, so this US\$938 million is almost certainly an overestimate.

enough to be worthwhile (see chapter 1). Nevertheless, Brazilian institutional investors are important to financing their government. As a result, this chapter will mainly discuss Brazil, complemented by briefer consideration of Turkey. It should be recognised, however, that across emerging markets, the growth of mutual funds has been strong, with assets rising by 96 per cent between the end of 1997 and June 2003 (IMF 2004: 140).

Characteristics of Institutional Investors

This section will deal with some of the important characteristics of institutional investors in general, before the remainder of the chapter focuses on differences between the investor types. Much of the contrast with bank and individual investors has been discussed in those chapters, and so will only be briefly repeated here as the potential general consequences of the institutionalisation of investments.

Lower Information Costs Reduce Home Bias

Institutions face lower transaction costs, including costs of information gathering, when compared to individuals (Davis 1996: 65; see Bodie 1990: 424 on pension funds). Institutions are also less willing than individuals to accept low levels of portfolio diversification, to the extent that regulation allows (De Bondt 1998; Goetzmann and Kumar 2003, 2005).⁸ That, at least in part, explains the weaker home bias relative to individuals. Even this lower home bias is nevertheless still highly significant to a government's ability to raise finance. Institutional investors can still benefit from 'non-fundamentally based familiarity' (Zhu 2002; see also Kumar 2004), which may serve to improve performance (Ivković and Weisbenner 2005). Interviewees' perspectives on locals' greater familiarity was mixed. Local investors had no doubts that living in the country meant their knowledge was greater than international investors, but whereas

⁸ It should be noted, however, that high levels of correlation between bond markets internationally (relative to equity markets) make diversification in bond markets less attractive (Davis and Steil 2001: 77).

Turkish and Lebanese investors were confident this gave them an advantage (see also chapters 2 and 3), in Brazil, the case study country in which international investors take the greatest interest (see chapter 5), there was a concern this did not necessarily lead to better investment decisions. The most widely given example was the political scandal which finally led to the resignation of Finance Minister Antônio Palocci in March 2006. Domestic investors saw the scandal as a reason for the market to weaken substantially, and sold accordingly. International investors, however, were more interested in the fact that Brazilian interest rates were relatively high, and continued buying. The international view prevailed.⁹ Overall, Brazilian institutional investors appear to be more cautious about the country's prospects, and therefore the speed of any fall in interest rates, than international investors.¹⁰ However, an international interviewee provided an example of where locals' better knowledge led to them making a better investment decision, so the situation appears, in the Brazilian case, mixed.¹¹

Institutions' Attitude to Risk

Overall, the question of risk aversion amongst individuals compared to institutional investors needs careful balancing. First, and most obviously, individuals are the

⁹ 'July 2005, when we had this huge political crisis, the locals got very bearish, they sold the market heavily...and the foreigners, they were looking to the global environment where the risk appetite was very benign and they were buying Brazil the same way as...buying other assets...and other locals lost money and all the foreigners made a lot of money' (proprietary trader, Brazilian bank, interviewed 29 August 2006); also hedge fund manager, Brazil, interviewed 31 August 2006; Head of Sales and Trading, foreign bank, Brazil, interviewed 30 August 2006.

¹⁰ 'I think you know country's culture, you know the flaws, you are more skeptical as to the capacities of the country to perform well, and...that acts both in a good and a bad way, not necessarily gives the ability to make more money' (hedge fund manager, Brazil, interviewed 31 August 2006); also Head of Sales and Trading, foreign bank, Brazil, interviewed 30 August 2006.

¹¹ 'A week ago there was an election. The Workers Party lost the presidency of the Congress. I have no idea what the name was and I didn't really know that the Workers Party used to have presidency of Congress but we walked in overnight and we read the news that the Workers Party had lost its president of Congress by a margin, so we sold and...I was talking to one of the locals and he says 'What was the name of the guy that lost his seat?'...and I said 'I have no clue', and he said 'Wait, everybody's selling and nobody know even the guy, what bills he was in favour of, what bills he was against, was he working with the opposition or was he not, was he good at making things happen in government'. Apparently the guy was very inept... and actually the opposition guy who won the seat was somebody who had worked with the Workers Party since the Workers Party came to power so at the end of the day spreads were unchanged, because it's a non-event' (emerging market bond trader, London, interviewed 18 February 2005).

investors in the institutions. Institutions aggregate individual investment, resulting in differences in behaviour that justify institutions being analysed separately from individuals. However, institutions' actions will still be influenced by the preferences and investment actions of their individual investors, because their ultimate aim is to maximise the funds they manage. Funds are attracted not only by performance, but by following an investment strategy that investors want. In the short term, also, the actions of investors can limit the freedom of action of an institutional investor (for example, see Kaminsky *et al.* 2001 on investor withdrawal from international mutual funds during the Asian crisis). The threat of investor withdrawals from their funds in the event of temporary losses is a significant potential 'limit on arbitrage' (Shleifer and Vishny 1997). The fact that institutional investors are seeking to meet the preferences of existing or potential investors has a dramatic effect on the nature of mutual fund, and even hedge fund, investment in Brazil (see below).¹² Second, institutional investors are generally more long term, but individuals frequently reinvest (see chapter 3). Institutional investors are generally also more diversified (Davis and Steil 2001: 52), with more foreign assets (*ibid.*: 30). Lastly, as discussed previously, individuals see their own government credit as the highest available, and therefore their risk aversion may serve to increase demand for government securities, rather than prompt diversification away from them.

Institutions are Less 'Buy and Hold', Less Likely to Take Contrarian Positions and More Likely to Herd

Institutions generally are more likely to engage in herding (for surveys of the literature, see Devenow and Welch 1998; Bikhchandani and Sharma 2001), and are far more likely than individuals to be well-informed about others' trading (Shiller and Pound 1989), a prerequisite for herding. Also, in marked contrast to the behaviour of individual investors in Lebanon and Turkey (see chapter 3), institutions are unlikely to stabilise

¹² Agency problems connected to the extent to which fund managers might follow their own interests rather than those of their investors (Bodie *et al.* 2005: 7) form a backdrop to much of the analysis of institutional investors, but will not be directly examined here.

markets through contrarian investment, thanks to their risk management framework (Davis and Steil 2001: 262), particularly ‘value at risk’ systems. Again in contrast to individuals, institutions are generally less likely to be ‘buy and hold’ investors (though see the contrast between different types of institutional investors below), evidenced by their higher turnover rates (De Bondt and Thaler 1994). Institutions are quicker to react to changing market conditions (Davis and Steil 2001: 103). They may ‘speed the adjustment of asset prices to fundamentals’, or, as Crockett (2007: 22) observes regarding hedge funds, contribute ‘to the “completeness” of markets’.¹³

Institutions’ Liabilities

Differences between their assets and liabilities are important to the comparison between institutional investors and banks. Institutional investors tend to match assets and liabilities more directly (Davis and Steil 2001: 334); in other words, they do not take the sort of risks, particularly the maturity mismatch inherent in taking short term deposits and making long term loans, that is integral to commercial banking. Pension funds, at least in theory (see below for Brazil, however), make long-term investments to match their long-term liabilities, paying pensions. Mutual funds do not face a mismatch between assets and liabilities, as at worst they can sell assets to meet redemptions, and their investors bear the price risk of those sales. Most institutions are unlikely to face the liquidity constraints of bank investors. The use of leverage by hedge funds, however, makes them an exception to this contrast.

Regulation of Institutions

The regulation of institutions is different from the approach to banks (Davis and Steil 2001: 334), with fewer liquidity and reserve requirements and greater focus on disclosure. The importance of this different regulation lies in the greater freedom,

¹³ The use of inverted commas highlights the difficulties of knowing precisely what a ‘complete’ market actually is. A complete market is an ideal that does have a technical definition: roughly, a market is complete if all risks can be traded. A complete market is therefore completely financialised.

relative to banks, for institutional investors to diversify their investments. Reserve requirements on banks, for example, limit lending activity. If the reserves can be held in government securities, rather than cash, then they serve to require a certain holding of government debt. Most institutional investors have fewer restrictions, although, as will be discussed below, this varies, with pension funds in particular subject to much tighter regulation. This regulation of pension funds, frequently mainly prudential, serves to increase investment in government bonds.

Institutionalisation and Government Policy Autonomy

Overall, therefore (and supporting the conclusions of chapter 3), institutionalisation in general decreases the government's ability to raise financing without following the policy preferences of international investors, as institutional investors demonstrate less loyalty to government debt than individuals and banks. However, some institutionalisation (particularly that involving pension funds) actually serves, at least initially, to increase policy autonomy. This is because a large preponderance of investment remains in government bonds, it is generally more likely to be in longer term securities and it is 'buy and hold' investment. Mutual funds, as they have so far developed in Brazil and Turkey, also invest mainly in government debt, though this is short term, and individual investors are able to sell their holdings at any time. Even in their early stages of development, mutual funds can be seen as offering advantages and disadvantages in terms of government policy autonomy. Only hedge funds, it will be argued, should be seen unequivocally as reducing government autonomy, due to even lower regulation and the ability to leverage and short, thereby demonstrating disloyalty.

The loyalty of institutions, then, is connected almost exclusively to the costs of exit. Institutional investors in emerging market countries are more numerous and smaller than commercial banks, and have diverse investment objectives, so are unlikely to be 'quality-makers'. Institutionalisation in general can be seen as reducing government

policy autonomy, but this varies depending on the particular institution. The following sections will deal with the types of institutions in turn.

Pension Funds

There are a number of important ways in which the nature of pension funds as investors makes them natural holders of government debt. Pension funds generally seek longer term assets (Borensztein *et al.* 2006): Turkish pension funds have called for longer term government debt issuance.¹⁴ They are also more naturally ‘buy and hold’, rather than active traders of securities (*ibid.*). The evidence as to whether institutionalisation in general has led to more long term saving is inconclusive, although Davis and Steil (2001: 293) conclude that ‘on balance’ it has. What can be said is that within the process of institutionalisation, pension funds should have a greater impact on making savings more long term than other institutional investor types, and ‘offsetting’ – holding more short term assets to offset the increased holding of long term assets – is insufficient, if it occurs at all, to prevent savings overall becoming more long term (Dicks-Mireaux and King 1983; Davis 1988). It must be noted, however, that it can be regulatory requirements to match assets and liabilities which serves to prompt demand for longer maturity investments; this was the case in the United States, where it was only after the passing of the Employee Retirement Income Security Act (ERISA) in 1974, requiring pension funds to hedge their liabilities, that ‘demand for long-term fixed-income securities has come primarily from pension funds’ (Bodie 1990: 446). Also of note is the move towards domestic equity markets in the larger pension fund systems, particularly the United States and the United Kingdom (although partially reversed in the latter), on the basis that equities represent the best long-term, inflation-proof investment (Bodie 1990 argues this advantage of equities is a fallacy). Nevertheless, the nature of pension funds’ liabilities (to pay pensions denominated in local currency) means that they favour

¹⁴ Department Head, Turkish Treasury, interviewed 30 November 2005.

their own domestic currency as the denomination of investments (Levy-Yeyati 2004¹⁵; Borenszstein *et al.* 2007: 157). Reisen and Williamson (1997) note this home bias of pension funds, but also suggest that defined contribution pensions may make them less conservative.

Pension Fund Regulation

Governments are able to regulate pension funds, with prudential justification, in ways that can have a significant impact on funds' investment decisions, and which can be seen to be closer to the regulatory approach to banks than to other institutions. In this regard, the use of a 'prudent investor' approach to regulation can be seen as akin to the Basel II advanced approach of relying more on the regulated institution's internal risk management systems than quantitative restrictions. However, even regulation that restricts investment other than in government bonds – enforced loyalty – cannot be seen as the sole explanation for pension fund holdings of government securities. As will be discussed below, regulation does not force investment in Turkish government bonds, and a similar situation can be seen in, for example, Danish pension funds' equity investments (Davis and Steil 2001: 97), and Bolivian overseas investment (Borenszstein *et al.* 2007: 156). In most of Latin America, however, regulations on foreign investment do limit cross-border activity, with a stated desire on the part of funds to invest more abroad (*ibid.*: 156, citing Cowan and Panizza 2006).

Other Explanations for Pension Fund Investment

Regulations do not always limit diversification, meaning that part of the explanation must lie in the nature of pension fund investment. Of particular importance in this regard, Coote (1993, cited by Reisen and Williamson 1997) found, in the relatively unrestricted markets of Australia, the Netherlands, Switzerland and the U.K., that the

¹⁵ Levy-Yeyati argues that pension funds, among others, would buy local currency bonds issued by the IFIs, which could fund IFI local currency lending.

internal restrictions of life insurance and pension funds set both a minimum and a maximum amount of foreign investment, and that the purpose of such investment was risk-reduction through diversification, not profit-maximisation.¹⁶ This contrasts with the yield-enhancement motivation of investment of individuals, and, in some cases, banks. In the less developed financial systems in emerging market countries, such risk reduction may well push investment into government bonds, aided by the fact that governments have the ability to tailor their financing to the needs of pension funds. Long-term securities are one example, but even more specific is the issuance of inflation-linked securities, as in both Brazil and Turkey.¹⁷

Turkish Pension Funds

In Turkey, before the pension reform of February 2002, private pension funds were small. In 2001, their assets were 2.3 per cent of GNP, compared to Brazil's 13.2 per cent of GDP, and 75 per cent in the United States (World Bank 2003: 39). Substantial growth is, however, expected. The new system is heavily regulated, serving to enforce loyalty to government debt. Contributors choose between funds that invest in government debt, equities or foreign bonds, but a minimum of 30 per cent must be invested in funds whose assets are at least 80 per cent government debt (PricewaterhouseCoopers undated: 19).¹⁸ Also, foreign investment is limited; a maximum of 15 per cent of contributions can be invested in funds with 80 per cent or more of foreign assets (OECD 2006: 26; PricewaterhouseCoopers undated: 19). Such restrictions are not uncommon in reformed pension fund systems, and serve to provide demand for government bonds to finance the transition from a state system which still has obligations to retirees (Borensztein *et al.* 2007: 154). Nor should the minimum investment in government bonds in Turkey be

¹⁶ Davis (1998: 383) finds that in those countries which apply 'prudent investor' rules (requiring only that pension funds make investments that a prudent person would make; see Bodie *et al.* 2005: 944 for a definition) rather than quantitative regulations, both equity and foreign investment are higher, but this may be linked to the size of pension funds in countries that apply such rules (see below).

¹⁷ Turkey renewed issuance of CPI-linked bonds in February 2007. For details see www.hazine.gov.tr/TUFE/tufe_brosur_ENG.pdf, accessed 20 April 2007.

¹⁸ Also Department Head, Turkish Treasury, interviewed 30 November 2005.

seen as particularly onerous; developed world pension funds on average hold around 25 per cent of assets in government bonds, with the figures for smaller advanced economies generally higher (*ibid.*). Pension fund holdings of government bonds are higher than 30 per cent, for example, in countries as varied as Austria, Italy, Singapore, Poland and Mexico (*ibid.*: 155).

Such regulations enforce loyalty, but their purpose is also prudential. These dual considerations are acknowledged by the authorities:

[D]uring the setting up of the private pension system...public sector borrowing requirement was very high. And [during] the discussion [in] parliament, we had then crisis in 2001...and that affect[ed] the situation...previously they say debt must be minimum 75 per cent or 50 per cent, so after the negotiation...we reduced it to 30 per cent...The second reason was in defined contribution system...investment risks are [borne] by the participant, not the...pension company...This is a very new situation for Turkish investors...due to lack of the financial education in Turkey...people do not know the risky investment or difference between government bonds and stock market securities...so if we invest [in] less risky assets in [the] long term...the variation will be less.¹⁹

Once again, as with the attitude of individual investors, the government's debt is seen as the least risky asset, as would be widely accepted in developed country financial markets. Therefore, it is seen as prudent to limit the pension funds' ability to diversify, despite a 'negative effect on the overall return of funds'.²⁰ It is accepted, however, that these limits, particularly the restriction on foreign investments, may prove temporary. In part this is the result of EU requirements as a result of the accession process, a form of internationalisation specific to Turkey. However, it is also the result of an acceptance that over time, the growth of funds will mean that they effectively outgrow the capacity of the Turkish markets.²¹ So there is likely to be liberalisation, contributing to financialisation, as the pension funds are allowed to trade different risks. This will reduce the percentage of funds flowing to government debt, albeit of a larger amount of

¹⁹ Department Head, Turkish Treasury, interviewed 30 November 2005.

²⁰ *Ibid.*

²¹ *Ibid.*

investment funds. The enforced loyalty of pension funds to government debt will therefore reduce over time. A similar process of increased regulatory forbearance can be seen in the development of the Chilean pension fund system (Holzmann 1997; Davis and Steil 2001: 231), with equity and international investment permitted in 1985 and 1989 respectively.

At present, however, the regulation is not a constraint on the Turkish pension funds' activities. Less than 1 per cent of assets are invested abroad, and 90 per cent of assets are in government bonds.²² This is the result of the investment choices made by both individual contributors and the pension fund managers. Turkish pension fund contributors choose the 'pension mutual funds' in which they invest, so it is important to consider the actions of individual investors themselves. Therefore, many of the observations which apply to individuals as direct investors are also appropriate here. Investors being generally 'buy and hold' is an example; individuals can change their fund choices four times per annum, but the weighted average of changes is less than one,²³ and the same attitude of seeing the government as the best credit prevails.²⁴ An 'individualized' pension fund may be able to act in a more contrarian fashion (Davis and Steil 2001: 264), and demonstrate loyalty to government debt. However, it should also be acknowledged that to the extent that the high percentage of government debt is simply the result of high Turkish interest rates (a 'crowding out' effect), there is little loyalty being shown. This is clearly expected to remain a factor: 'in the coming...5 or 10 years...most people [will] continue to invest in government bonds... Because [the] public sector borrowing requirement will continue to be higher in Turkey. So that means the government...will offer some competitive rate of interest'.²⁵ Nevertheless, there are a number of ways in which it is the current nature of the pension mutual funds that is raising the cost of exit from government debt, and so resulting in loyalty that is not enforced or the result of high interest rates. For example, if international funds are sold,

²² Department Head, Turkish Treasury, interviewed 30 November 2005.

²³ *Ibid.*

²⁴ *Ibid.*

²⁵ *Ibid.*

the settlement period (the time before the sale proceeds are actually received) is longer (7 days) than for government bond funds (1 day),²⁶ which can act as a disincentive.

More significantly (given the low turnover of pension funds), it is expensive to invest in foreign funds.²⁷ Turkish managed foreign funds are small, meaning they are expensive to manage relative to their size, and so have higher fees. Foreign-managed funds are also likely to be relatively expensive, as the fund manager must have an incentive to offer them in another country. Small funds face many of the same issues regarding transaction costs as individuals, if at a reduced level. As funds become larger, many transaction costs decrease relative to the size of the fund. Reduced transaction costs increase the ability to invest in a broader variety of assets at acceptable cost, including foreign assets but also domestic equities. As Studart (2000: 36) observes, 'the size of the institution does matter substantially:...the search for diversification is costly and only compensated if economies of scale are achieved'. Davis and Steil (2001: 299), considering developed country pension funds, note that the percentage of foreign assets increases as fund sizes increase, suggesting the importance of reduced transaction costs as the volume of potential foreign investment increases. The same is likely to be true for domestic equity investment, another alternative to investment in government bonds. In 1994, U.K. pension funds had 70 per cent of their assets in equities, compared to only 12 per cent of individuals' assets. In the United States the figure was 48 per cent (19 per cent for individuals), although in Germany it was only 18 per cent (6 per cent) (Davis 1996: 75). This is another example of financialisation. However, it should also be recognised that the generally smaller size of emerging market economies, combined, at least in the short term, with smaller pension fund industries relative to the size of the economy,²⁸ means that the transaction costs of diversification may remain high relative to larger developed countries, leading to a continued greater propensity to purchase government securities.

²⁶ Department Head, Turkish Treasury, interviewed 30 November 2005.

²⁷ *Ibid.*

²⁸ The assets to GDP of the Chilean pension funds now exceed the average for the advanced economies (Borensztein *et al.* 2007: 153) and the average for Latin America overall is similar to developed countries excluding the United States, Canada and the United Kingdom (*ibid.*: 154).

The higher government bond ownership in smaller, developed country pension funds such as Austria and Italy (Borensztein *et al.* 2007: 154), and the high foreign ownership by the large Dutch pension funds (Davis and Steil 2001: 101) may be evidence to support such a view. However, regulation also appears to play a large part: the greatest restrictions are imposed in the countries with the smallest domestic capital markets (Bodie 1990: 453).²⁹

Brazilian Pension Funds

The pension fund industry in Brazil is of much longer standing, and is much larger, both in absolute terms and relative to GDP, than the Turkish industry. The establishment and regulation of closed (company policies offered only to employees) and open pension funds dates from 1977 (Leal and Carvalhal-da-Silva 2006: 10; Yermo 2000; Medici 2004). Pension fund assets were equivalent to about 16 per cent of GDP in 2004, higher than Spain, France, Germany or Italy (Borensztein *et al.* 2007; Yermo 2000: 5). More than three quarters are closed schemes. Furthermore, the industry has been highly concentrated, with the top 10 funds controlling over 60 per cent of investments in 1998 (Studart 2000; see also Yermo 2000: 5). The Banco do Brasil pension fund alone controls over 30 per cent of the assets. Unlike in Turkey, then, and in many emerging countries, some of the pension funds in Brazil have the necessary size to make successful diversification decisions. The financial markets in Brazil also offer alternative assets, even without investing abroad, through the equity market, bank certificates of deposit and company bond issuance. Large pension funds may be in a position to see themselves as ‘quality-makers’, and therefore be willing to buy bonds as a result of this loyalty. Certainly, state pension funds have in the past bought government bonds at times of market weakness,³⁰ but the fact that they are government controlled seems as likely to explain their behaviour. During the global market weakness of May 2006, when

²⁹ An alternative viewpoint is that larger economies such as the United States offer diversification without the need to invest abroad (Reisen and Williamson 1997: 237). However, the empirical evidence does not appear to support this.

³⁰ Proprietary trader, Brazilian bank, interviewed 29 August 2006.

foreign investors sold inflation-linked bonds, pension funds did not step in to support the market, despite holding sizeable volumes of these bonds themselves, and having a natural interest in such assets. At least part of the explanation for this lies, however, in a scandal regarding pension funds, which meant they have chosen to operate only in the primary (new issue) market, because prices there are transparent, and so have avoided trading in the secondary market.³¹ At best, the case for large pension funds expressing Hirschman's second conception of loyalty must be considered unproven.

Enforced loyalty through regulations is an important part of determining the choice of assets. Legislation from 1978 limited investment in government bonds to 50 per cent of assets, and listed private company securities to 20 – 40 per cent, but this was changed in 1994. Government bonds could now be up to 100 per cent of assets, and private fixed income 80 per cent (although with other limits related to credit quality), with restrictions on other asset types (Studart 2000; Yermo 2000: 19). The interpretation of the impact of these regulations varies. Studart (2000: 32) argues that the intention of the 1994 legislation was to increase flexibility, and in particular to move investment from government bonds and real estate to private sector securities: 'the main characteristic of the 1994 legislation was a stimulus given to asset diversification'. Leal and Carvalhal-da-Silva (2006: 45) disagree: 'This regulatory privilege of treasuries is one of the instruments to crowd out corporate debt'. They surveyed 28 institutions (including banks) and found that half were subject to regulatory constraint on their portfolios (*ibid.*: 58). Holzmann 1997: 163 similarly finds Chilean pension funds are as diversified as they are allowed to be. Leal and Carvalhal-da-Silva do not provide any breakdown of the types of institutions they survey, but the most regulated of the institutions surveyed are banks and pension funds. If permitted, 58 per cent would buy more asset-backed securities, 57 per cent more foreign assets, and 45 per cent more bonds issued by Brazilian companies. 22 per cent would reduce investment in government bonds, yet '[t]he federal government's gargantuan funding needs induces it to pass regulation

³¹ Head of Trading, foreign-owned bank, Brazil, interviewed 4 September 2006; proprietary trader, Brazilian bank, interviewed 29 August 2006.

favoring its own debt in detriment of the development of the corporate financing market' (*ibid.*: 60).

It is noteworthy, however, that 17 per cent of those surveyed would *increase* their government holdings if allowed to do so, and 61 per cent would leave it unchanged (*ibid.*: 71). For over three quarters of institutional investors, therefore, regulations do not serve to channel investment into government bonds. Two factors appear to be at work. First is the standard crowding-out of high interest rates on government bonds (Chan-Lau 2004: 19). Brazilian government bonds, since the 1994 Real plan, have offered exceptionally high real interest rates. Pension funds have not felt the need to buy anything else to achieve attractive returns,³² and the historically high volatility of the market has made them reluctant to move beyond the short term (Rojas-Suarez and Weisbrod 1996 make this point regarding Latin American institutional investors generally). They are subject to the same 'CDI culture' – a focus on investments linked to the inter-bank overnight interest rate – as individuals, despite the fact that they have long term liabilities.³³ Regardless of regulation, therefore, much depends on the movement of real interest rates – which had fallen, by May 2006, to their lowest level since the anti-inflation Real plan in 1994 (Leal and Carvalhal-da-Silva 2006: 5). This, of itself, started to cause the pension funds to move to longer term assets. The increased economic stability the lower interest rates represent encourages the holding of riskier assets (Studart 2000: 39), and the falling real rates force the pension funds to consider alternatives to short term government securities.³⁴

³² Hedge fund manager, Brazil, interviewed 11 September 2006.

³³ '[P]ension funds need to invest long term, but because of high inflation, high volatility, even the pension funds invest in short term bonds, linked in CDI' (senior official, Ministry of Finance, Brazil, interviewed 6 September 2006). 'What is crazy here is we have pension funds, which is for retirement...I'm not sure about the duration...but it should be 15 years or something like this. They buy this overnight indexed bonds, it doesn't make any sense. They should buy inflation linked, we still have bonds inflation plus 9 per cent, it's a lot for any one year, any country, but they don't buy it' (Head of Sales and Trading, foreign bank, Brazil, interviewed 30 August 2006).

³⁴ '[W]hen the short term interest rate starts to decrease very fast then they start to move fast because they [were] reaching the benchmark buying the CDI, buying short term, but now it's not totally true' (senior official, Ministry of Finance, Brazil, interviewed 6 September 2006).

The government has been active in encouraging this move through more than falling interest rates, however, demonstrating the authorities' ability to influence pension fund investment in ways other than quantitative limits. Issuing long term inflation-linked securities has been one important part of an on-going strategy to encourage the pension funds into longer maturity investment. In 2005, inflation-linked bonds were 14.37 per cent of total domestic issuance (Leal and Carvalhal-da-Silva 2006: 27). Governments are the most natural issuers of inflation-linked securities,³⁵ and so investors such as pension funds, which have demand for these bonds, are likely to remain in government securities as a result. Exit – moving to another asset – is likely to result in the cost of not investing in an asset which most closely matches their liabilities. The Brazilian authorities have attempted to increase this cost by introducing liability management guidelines to encourage the matching of assets and liabilities (with potentially a similar impact to the US ERISA rules),³⁶ although the extent they are followed has only slowly increased.³⁷ Part of the reason for remaining in short-term investments has been the pressure on managers for short-term performance.³⁸ In an attempt to counter this, pension funds were required to set and publicise a target return. Most chose one linked to inflation, the obvious choice for a pension fund, and the average is inflation plus 6 per cent.³⁹ Such a

³⁵ Governments' future revenue, taxation, is an inflation-linked (real) income. For companies, future earnings before interest and tax are less directly linked to inflation, even if they are 'more real than nominal' (Barclays Capital 2007). Note, however, that an ability to use swaps to hedge the risks of issuing inflation-linked bonds (further financialisation) would increase issuance by borrowers other than governments, creating competition for government financing.

³⁶ Senior official, Ministry of Finance, Brazil, interviewed 6 September 2006.

³⁷ 'We had the regulations but they were free to choose...and they end up choosing very short term maturities, so government had to look again and...there was a new reform trying to match assets and liabilities, but it took some time.... You think that when you have liabilities that are long term it will be natural for pension funds to increase the maturity of their assets because that's the most prudent thing to do, independent of the regulations, but sometimes the decision of the asset manager...does not always lead him to choose the right [strategy]. He may have short term incentives, sometimes his own bosses, his fear of losing his job if he loses money in the short term, so there are incentives to be short and I think the new regulation, it's...already six years, try to force him to be longer' (former Deputy Governor, Banco Central do Brasil, interviewed 11 September 2007).

³⁸ 'The pension funds typically come to you and say, well I am a long term investor, I will evaluate you in the long term...but every month...they are evaluating each asset manager (Head of Fund Management, Brazilian bank-owned fund management company, interviewed 30 August 2006); also former Deputy Governor, Banco Central do Brasil, interviewed 11 September 2007.

³⁹ Senior official, Ministry of Finance, Brazil, interviewed 6 September 2006. This may appear high, but was driven by the high real interest rates then prevailing, and a need not to be seen as targeting a low

stated target means that a move to inflation-linked longer term bonds makes obvious sense: ‘If you’re a pension fund manager and you see the government issuing bonds for 30, 40 years at inflation plus nine, you should buy them all and hold, and you’ll have some surplus over the years that you can diversify...your portfolio’.⁴⁰

Such behaviour is encouraged by another reform, of the taxation of individuals on their pension funds. Longer term contributing receives lower taxation (ANDIMA⁴¹ 2006: 2),⁴² with the income tax falling from 35 per cent for contributing for 2 years or less to 10 per cent for contributing for over 10 years. This reduces the risk of withdrawals for the pension fund managers, encouraging both longer term investment, and pension funds acting as a stabilizing force in the market (see Shleifer and Vishny 1997 for how fund withdrawals might limit arbitrageurs’ reactions to misaligned prices). Pension funds would ordinarily be expected to be among those investors that buy when the market is weak, taking a longer term view, even if they have not done so in Brazil.⁴³ Accounting, or performance management, similarly can act as a disincentive. Assets can be held without marking them to market if there is a specified liability matching the asset. This ability not to mark to market has an effect similar to the investment account for banks (see chapter 2). For a mature defined benefit scheme, this ability is common. Otherwise, the asset (including holdings of mutual funds) must be marked to market, while the liability is not. In a weak market, such marking-to-market can create a serious mismatch.⁴⁴ However, the impact of the difference in accounting relative to other institutional investors must be put into perspective. Only banks, with their investment

return relative to competitors. Pension funds in both Germany and the United Kingdom achieved this return per annum, 1970 – 95 (Davis and Steil 2001: 106).

⁴⁰ Hedge fund manager, Brazil, interviewed 31 August 2006.

⁴¹ Associação Nacional das Instituições do Mercado Financeiro, National Association of Financial Market Institutions, Brazil.

⁴² Also senior official, Ministry of Finance, Brazil, interviewed 6 September 2006.

⁴³ ‘[I]t’s clear for me that the pension funds that needed to do a long term investment should buy more bonds during the crisis because the price is very cheap, but with the culture of the CDI they didn’t do this’ (senior official, Ministry of Finance, Brazil, interviewed 6 September 2006); also trader, foreign bank, Brazil, interviewed 29 August 2006.

⁴⁴ Former Governor, Banco Central do Brasil, interviewed 29 August 2006; hedge fund manager, Brazil, interviewed 31 August 2006; former Deputy Governor, Banco Central do Brasil, interviewed 11 September 2006.

accounts, have a similar ability not to mark to market, and the nature of pension funds means they are better able to continue to hold investments in the event of a very weak market. They are better able to demonstrate loyalty.⁴⁵ While this ‘buy and hold’ by pension funds is partly due to the corruption scandal discussed above, but it is also in line with the requirement to meet long term liabilities.⁴⁶ In their meetings with the Ministry of Finance to discuss the government’s debt issuance, the focus of the pension funds has been not on improving market liquidity, but on structuring bonds that best meet their liabilities through interest being paid on convenient dates.⁴⁷

Pension Funds and Government Policy Autonomy

Pension funds fit closely with the idea of financialisation increasing as investors’ activities change, and of those changes having a significant impact on government policy autonomy. The initial establishment of funded pension funds, usually in place of a pay-as-you-go government scheme, is in itself an example of increased financialisation. The risks inherent in the providing of pensions (including investment risk, and longevity risk) are now managed through the market, not assumed by the state. This initially serves to increase government policy autonomy through the ability (and prudential requirement) to regulate investment. This regulation has generally served to increase demand for government securities, as is the case in both Brazil and Turkey. Over time, however, a number of processes serve to increase financialisation. Pension funds increase in size. Size results in economies of scale, which makes the analysis of a broader range of investments cost effective, both through increased ‘in-house’ analytical capacity, and as a result of financial intermediaries (including foreign) having the incentive to offer their own research services in return for trading business. Increased

⁴⁵ ‘[E]ven in a crisis it’s not like they’re going to go broke. They could have a reduction on the net asset of their portfolios but in the end they’re going to hold it...through, because their liabilities are long term liabilities. They have a flow of liabilities but if they’re in, say...government bonds or a little bit of stocks that have...dividends...it’s not like they have the two unmatched and they’re not leveraged so they have so much concern about going broke’ (trader, foreign bank, Brazil, interviewed 29 August 2006).

⁴⁶ For Brazil, hedge fund manager, Brazil, interviewed 11 September 2006; trader, foreign bank, Brazil, interviewed 29 August 2006.

⁴⁷ Senior official, Ministry of Finance, Brazil, interviewed 6 September 2006.

size also increases the degree to which pension funds can be seen as having outgrown the domestic government bond market, and therefore requiring regulatory forbearance to allow diversification, into such assets as domestic equities and foreign markets. Chile is an example of such a situation. Pension funds own around 85 per cent of the government bond market (Borensztein *et al.* 2007: 155), and needed to be allowed to increase their investment in other assets as a result. In the case of Chile, such liberalisation does not have a material impact on the government's ability to finance itself, because of the borrowing requirement relative to the capacity of loyal investors (one of the factors which has an influence on the *height* of the autonomy curve on the y axis. See chapter 6), but the change nevertheless means that, at any given level of borrowing, the Chilean government will be less autonomous from the policy preferences of international investors.

The attitude of the government is obviously central to this process of financialisation, as this will determine the nature of regulation, and it appears the case in Brazil that the authorities wish to see this asset diversification, as a means to support the development of broader capital markets.⁴⁸ In 2002, for example, pension fund regulations were changed to allow investment in alternative assets, including private equity. The attitude of the authorities to any development of the financial markets, and therefore to liberalisation, represents a significant impact on the speed of financialisation (supporting Helleiner's [1994] view of financial globalisation). For example, the development of a domestic equity market increases the potential alternative assets available to those pension funds, reducing the amounts which will be invested in government bonds.⁴⁹ Taxation will also serve to influence the speed of pension fund growth. It must also be recognised that the establishment of a private pension scheme, and its growth, creates pressures for further liberalisation, and therefore financialisation, particularly through

⁴⁸ '[W]e already have moved a long way to reducing the crowding out provided by the public sector and reducing the share that domestic debt is channeled through financing the government. I think we have more and more a very favourable environment for development of deeper capital markets in Brazil' (senior official, Banco Central do Brasil, interviewed 5 September 2006).

⁴⁹ Pension funds will obviously also assist the development of an equity market if they are permitted to invest.

the desire to maximise investment performance and minimise risk for pension fund contributors, a substantial body of voters. The IMF has argued specifically for liberalisation of investment abroad as pension fund assets grow (IMF 2004: 144), while recognising the macroeconomic risks of such outflows. Pension funds may also use liberalisation to invest in other types of institutional investors. Similarly, growth in pension fund assets may increase financialisation through increased internationalisation in another way, as international financial market actors look to trade securities with the pension funds, and/or foreign pension fund providers seek to become involved in the market (with potential support through the World Trade Organisation).

Although government policy autonomy decreases as financialisation increases, the nature of pension funds as investors, discussed above, continues to be important when considering pension funds' position on the 'autonomy curve' relative to other institutional investors. Pension funds are longer term, 'buy and hold' investors, and very unlikely to have investment mandates that include shorting. Their investment needs can be recognised in accounting guidelines (such as in Brazil) that means some of their portfolio is not marked to market, with influences similar to the commercial banks' investment books. Pension funds' liabilities are inflation-linked, making them natural buyers of long maturity inflation-linked bonds, of which governments are natural issuers. They have domestic currency liabilities, increasing their home bias. Lastly, regulation of pension funds for prudential reasons (even if only the 'prudent investor' rule) is expected and easily justifiable, and frequently serves to increase the demand for government bonds. For all these reasons, pension funds serve to have the least detrimental impact on government policy autonomy, and, in an environment of relatively low financialisation, where pension fund assets are disproportionately invested in government bonds (as in Turkey), serve to increase autonomy. Compared to an unfunded government 'pay as you go' system, the development of a private scheme also, over time, decreases government expenditure. The development of pension funds can be seen as a process which initially is likely to increase government policy autonomy, with that autonomy decreasing as financialisation increases, but with pension funds always

representing a reduced loss of autonomy relative to the development of mutual funds and hedge funds, which the next two sections consider.

Mutual Funds

In this thesis, the common financial market differentiation of mutual funds is followed, as it serves a useful purpose for an analysis of government policy autonomy. Mutual funds are taken to be pools of investment assets that cannot, in significant amounts, either borrow money to leverage their investments, or take short positions. Nor are mutual funds taken as having long term liabilities, against which they acquire assets. Mutual funds is used here to denote those institutional investors that invest with the aim of maximising returns, to be paid to investors either as income or capital gain, while following an investment strategy determined by the particular investment mandate of the fund. This can involve investing for the short or long term, for income or capital gain, and in predetermined financial markets and/or geographical areas.

The most obvious distinguishing feature of mutual funds is that they have a specified investment strategy which is outlined to investors, usually in a prospectus (Bodie *et al.* 2005: 112). Investors choose a mutual fund that follows the investment strategy they desire, be that a low-risk fund that invests in short maturity government bonds, or a higher-risk fund concentrating on Asian equities.⁵⁰ Investors should know what risks they are taking. This relatively high transparency contrasts, to varying degrees, with other types of institutional investors, and with banks. A depositor with a bank, or a contributor to a defined benefit pension scheme, has limited knowledge of the lending or investment strategies of the bank or pension provider, and takes risk on the institution. Strong regulation of the activities of such investors can therefore be seen as appropriate. Mutual fund investors' risks are directly the investment decisions of the fund manager of the fund in which they invest (Khorana *et al.* 2005: 146). Regulations therefore tend to

⁵⁰ In the United States, the Investment Company Institute lists 21 different investment objectives (Remolana *et al.* 1997: 34).

be focused on ensuring appropriate disclosure, to prevent or limit investment in companies related to the fund manager, or to limit concentration of assets and direct involvement in management of companies (Bodie *et al.* 2005: 942). Where the investors in mutual funds are institutions or individuals who can afford losses, such a relatively *laissez-faire* attitude to regulating mutual fund investment can be seen as generally appropriate. Pension funds can be regulated appropriately, and accepted as sufficiently sophisticated investors to choose suitable mutual fund investments. Less wealthy individuals, however, may continue to require regulatory protection. There is ample evidence, particularly from emerging markets, of individual investors seemingly not fully understanding the risks they were running (see IMF 2004 on examples from Colombia, Korea, Thailand, Hungary and Poland; Borensztein *et al.* 2007: 160 for Colombia). In Brazil, in May 2002, a Banco Central do Brasil move to enforce mark-to-market rules, causing, in a weak market, net asset value markdowns of up to 2 percent in a day,⁵¹ prompted withdrawals from surprised investors.⁵² Regulation of mutual fund investments for investor protection is therefore not uncommon.⁵³ As will be discussed below in the case of Brazil, such regulation can create a similar situation to the prudential regulation of pension funds and banks – greater investment in government debt.

Mutual funds therefore seek to meet the expectations of their existing and prospective investors. Just as was discussed regarding defined contribution pension funds, the actions of individuals investing in mutual funds are important, including perhaps prompting herding by mutual funds. Herding, investors copying the actions of other

⁵¹ Senior official, Ministry of Finance, Brazil, interviewed 6 September 2006

⁵² '[Y]ou can imagine what was the impact to the less educated saver, that when they were used to seeing quotes going up every day because of the daily interest, and then suddenly change in regulations triggered a loss and some didn't understand why and there were...massive withdrawals' (Head of Trading, foreign-owned bank, Brazil, interviewed 4 September 2006). '20 billion Reals, \$10 billion, was withdrawn from the mutual funds' (senior official, Ministry of Finance, Brazil, interviewed 6 September 2006). '[T]he DI mutual funds...had used swaps to enhance their returns, so...they were buying dollar linked bonds and swapping them to floating rate and ...they weren't marking the underlying securities to market, so they were acting as if they were just holding a floating rate bond' (economist, investment bank, New York, interviewed 17 May 2006).

⁵³ Khorana *et al.* (2005) find a strong correlation between regulation protecting investors and the size of the mutual fund industry.

investors rather than making independent judgements, lies at the heart of ‘panic-stricken’ explanations of the Asian and subsequent financial crises (Kahler 2000). If the ‘panic-stricken’ analysis is correct and if mutual fund ‘panic’ can be explained through investor withdrawals, mutual fund actions are in contrast to the activities of individuals as direct investors (see chapter 3). Empirical findings in this regard are, however, mixed, particularly once the focus moves from investors in general to mutual funds in particular, even if the focus remains international mutual funds. In the Asian crisis, for example, the bulk of the withdrawal of international funds was by commercial banks, not mutual funds (Cailloux and Griffith-Jones 2000: 1; see also, on Brazil in 2002, Hardie 2006), although there is evidence of mutual fund selling in the expectation of redemptions contributing to pan-Asian contagion (Park and Song, 1998, cited by Griffith-Jones *et al.* 1998). Potentially significant in this regard are the findings of Borensztein and Gelos, who show moderate herding behaviour amongst international emerging market equity mutual funds (see also Kaminsky *et al.* 2000, and, for the United States, Wermers 1999), but conclude (2003: 61) that ‘the case against emerging market mutual funds [as herders in crisis situations] remains to be proven’. Remolana *et al.* (1997), furthermore, looking at the short-term reaction to market movements, find no evidence to suggest that investors’ reaction to market weakness could cause a spiral of falling prices. Despite this mixed evidence, however, a confident comparison can be made with pension funds, which are relatively illiquid for their contributors. Mutual fund managers are more likely to face withdrawals by their investors than pension funds, and therefore should tend to be shorter-term investors.

Brazilian Mutual Funds

Brazilian mutual fund assets represent 28.4 per cent of GDP, the highest in Latin America, compared to an average of 47.2 per cent in the advanced economies (Borensztein *et al.* 2007: 153). Brazil’s figure was, at the end of 2001, nevertheless similar to Italy, Korea, Spain and the United Kingdom (World Bank 2003: 43), and in overall size the eleventh largest in the world. Most significantly for this study, Brazilian

bond fund assets are the world's fourth largest (as at end 2005; Comissão de Valores Mobiliários ['CVM'] undated: 19).

'CVM Instruction, or Rule, 409'⁵⁴, effective from November 2004, combined with agreed self-regulation by the National Association of Investment Banks (ANBID),⁵⁵ divides funds into seven types, with different requirements for portfolio composition and risk factors, and established a 'qualified investor' (able to make more risky investments) as having financial investments of at least R\$300,000 (US\$150,000; Queiroz *et al.* 2004).⁵⁶ 'Foreign Debt' funds were required to invest at least 80 per cent of net assets in Brazilian government international bonds. Regulation is thus obviously very important. Leal and Carvalho-da-Silva (2006) also note discussions whereby the market regulator, the CVM, was considering a regulation which would limit mutual funds offered to non-qualified investors (those with a minimum initial investment of less than R\$300,000) to 30 per cent of assets in private debt (with other limits). This potential legislation further demonstrates the complimentary relationship between prudential legislation and encouraging ownership of government bonds. Leal and Carvalho-da-Silva criticise this and similar regulations for treating Brazilian government debt 'as if [government bonds] were risk free' (2006: 61), and question whether the most creditworthy Brazilian companies are not at least as safe an investment as the government. This may be the case, but prudential regulation frequently acts to privilege the holding of government debt. The ability to regulate financial market actors, and thereby to enforce loyalty, remains central to the government's ability to raise financing, whether the regulation's aims are prudential or specifically aimed at maximising investment in government debt. The obvious point that domestic financial institutional investors can be more easily regulated has already been made. The differential importance of prudential regulation is

⁵⁴ See www.cvm.gov.br/ingl/indexing.asp, accessed 2 May 2007.

⁵⁵ See www.anbid.com.br/institucional/CalandraRedirect/?temp=5&proj=ANBID&pub=T&comp=sec_AUTO_REGULACAO&db=CaISQL2000&docid=20314BECC734D2CF832571D20052D8E6, accessed 2 May 2007.

⁵⁶ The industry also follows a self-regulatory code, available at http://www.anbid.com/downloads/selfregulation_code.pdf, accessed 1 May 2007.

also a central difference between types of institutional investor. The longer term nature of pension fund investment, and its relative illiquidity for the contributor, means regulation is likely to be more stringent than for mutual funds. This means that, *ceteris paribus*, a mutual fund, rather than pension fund, dominated government debt market is likely to offer lower policy autonomy to the government, because of lower 'enforced loyalty'.

In reality, the Brazilian authorities disagree that they are seeking to crowd out the private sector. They claim to be doing the opposite, and actively encouraging market development.⁵⁷ This development has included attempts to make the market more liquid (i.e., easier to trade) and to encourage foreign participation by, in February 2006, exempting foreign investors from income tax on gains in government domestic bonds. This demonstrates a further way the government can influence investor decision-making through taxation. In the case of foreign investors, the removal of taxation is very much as the 'race to the bottom' globalisation literature might predict (for review, see Drezner 2001), although it should be recognised that by making it easier for foreign investors to enter, the authorities aim to reduce yields and increase maturities on government debt, so effectively indirectly recouping any lost taxation. In the domestic market, however, taxation is used in a different way, to lengthen the maturity of mutual fund investment. From 1 January 2005, funds have been taxed on a differential basis depending on the average maturity of their investments, declining from 22.5 per cent for up to 180 days to 15 per cent for over 720 days.⁵⁸ The measure, combined with falling interest rates and greater economic stability, appears to have been, at least in part, successful. The Ministry of Finance, to accommodate increased mutual fund demand for longer maturity

⁵⁷ 'Nowadays essentially you...have a lot of flexibility in terms of picking what portfolio you want. There is very, very little of this captive demand...for government securities. I think on the contrary...we're trying to provide incentives exactly for people to go into public sector or private sector instruments so as to provide demand for the securitised products and to provide room for financial innovation to boom' (senior official, Banco Central do Brasil, interviewed 5 September 2006); also former Deputy Governor, Banco Central do Brasil, interviewed 11 September 2007.

⁵⁸ Senior official, Ministry of Finance, Brazil, interviewed 6 September 2006. Because the tax is based on average maturity, rather than duration, investors can still benefit if the fund holds, say, government bonds maturing in 3 years, but with the return linked to short term interest rates.

paper, launched an exchange offer, buying shorter maturity bonds and issuing in exchange longer maturities. By the end of August 2006, 85 per cent of funds were classified as long term, although this classification required average maturities of only over 1 year,⁵⁹ and funds could still buy floating rate debt to minimise interest rate risk. Governments have a lower capacity to use regulation of mutual funds to influence investment activities than is the case with pension funds, but retain some capacity nevertheless.

The mutual fund industry in Brazil is overwhelmingly invested in bonds. At the end of 2001, bond funds made up 76.4 per cent of assets (figures from Khorana *et al.* 2005: 170; author's calculation), falling to 68 per cent by 2006 (CVM undated: 34). The reason for this imbalance is clearly not the size of the underlying financial markets. Equity mutual fund assets represented only 4.6 per cent of the equity market at the end of 2001, while bond mutual funds were 22.3 per cent of the total credit market (*ibid.*). Nor can it be explained entirely by regulation. The main reason is the demands of investors. The short term 'CDI culture' also influences mutual funds. Investors therefore have daily liquidity. This CDI culture dates from at least the 1980s, when government debt became effectively 'indexed money' and therefore a protection from inflation (Welch 1993: 14).⁶⁰ It is also noteworthy that mutual fund investment in Brazil is very much a direct alternative to bank deposits.⁶¹ Banks control around 80 per cent of mutual fund assets,⁶² and offer mutual funds as an alternative to deposits.⁶³ Funds can be bought

⁵⁹ Senior official, Ministry of Finance, Brazil, interviewed 6 September 2006.

⁶⁰ Also Deputy Head of Department, Banco Central do Brasil, interviewed 30 August 2006.

⁶¹ '[I]nvestors in Brazil are still addicted to daily liquidity with floating rate type of instruments, therefore the CDI type of fund, so called daily inter-bank deposit rate is the preferred type of fund, sort of the safest. People are willing to have lower yields...because it's very safe' (senior official, Banco Central do Brasil, interviewed 5 September 2006).

⁶² Head of fund management, Brazilian bank-owned fund management company, interviewed 30 August 2006.

⁶³ '[W]hen they buy...a fixed income fund in a branch, typically they are buying the closest thing you have to a savings account. You still have this ideal of safety, an investment which is solid, which faces very limited risk' (Head of fund management, Brazilian bank-owned fund management company, interviewed 30 August 2006).

in amounts as low as R\$100-200 (US\$50-100).⁶⁴ The banks have an incentive to do this. They earn high fees,⁶⁵ and avoid using their balance sheets, thereby avoiding the exceptionally high reserve requirements on bank deposits.⁶⁶

The expectation of investors that their mutual funds will perform like bank deposits means they should have low volatility, and, importantly, influences the benchmark chosen. The market has been dominated by funds which choose as their benchmark the Brazilian overnight interbank lending rate ('CDI'). The result is that 'the funds...are CDI slaves',⁶⁷ investing in short maturity government bonds linked to the Banco do Brasil's discount rate, the SELIC.⁶⁸ The CDI and the SELIC are both overnight interest rates, so the funds are taking minimal interest rate risk, but substantial credit risk on the government. A policy by the authorities to reduce issuance of this floating rate debt has seen it fall from 61.4 per cent of domestic government debt in 2003, but in January 2007 it still represented 38.9 per cent of outstanding debt.⁶⁹ 'Slaves' the funds may be, but it has historically not been a particularly onerous slavery. A requirement to beat bank deposit rates can be met through this strategy of low risk investment in short term government bonds with a floating interest rate.⁷⁰ The funds also tend to be 'buy and

⁶⁴ Head of fund management, Brazilian bank-owned fund management company, interviewed 30 August 2006.

⁶⁵ '[B]anks themselves provide an incentive for people, once you go into a bank and you get your account manager and you say, where to invest, most of the time they would say, well I do have this nice set of funds. Why? Because...people are attracted to the gross yield and they would not ask, what is the administration fee? And typically they'd charge 5 per cent in the most popular funds because they knew that people were not checking so...it was very profitable for institutions to offer to their clients funds instead of offering...them deposits' (senior official, Banco Central do Brasil, interviewed 5 September 2006).

⁶⁶ Reserve requirements of 45 per cent on current accounts are amongst the highest in the world.

⁶⁷ Proprietary trader, Brazilian bank, interviewed 29 August 2006.

⁶⁸ Head of fund management, Brazilian bank-owned fund management company, interviewed 30 August 2006.

⁶⁹ www.stn.fazenda.gov.br/divida_publica/downloads/BEST_Europe_mar07_Public_debt.pdf, accessed 3 May 2007.

⁷⁰ '[T]hey don't need to take too much risk especially if you are a big retail fund, you just buy short term paper, floating, more than 50% or around 50% of the debt is floating, CDI linked so it is actually the benchmark they have, so it is pretty easy for them to manage their book' (proprietary trader, Brazilian bank, interviewed 29 August 2006).

hold' on these short term investments.⁷¹ The Brazilian mutual fund business can be a summed up as 'a bank business where they earn a fee for managing money, giving the benchmark'.⁷² It represents loyal investment in government bonds, but its floating rate, short term nature has limited its attractiveness for the government as a borrower compared to pension fund investment. While pension funds would naturally be expected to be longer term investors, mutual funds, as a direct alternative to short term deposits, will be, in their early stages, much shorter term. Furthermore, as financialisation increases, the choice of investments for, and offered to their investors by, the mutual funds also increases, including equities and debt issued by companies or banks. This process has begun in Brazil, as those mutual funds that can diversify their investments have begun to search for higher yields by investing, for example, in bank certificates of deposit.⁷³ More sophisticated investors already invest in alternative assets. Although increased financialisation may lead to a willingness to invest in longer maturities, it will also lead to a lower proportion of investment going into government bonds, limiting the ability of the government to finance itself, and therefore government policy autonomy.

Turkish Mutual Funds

The Turkish mutual fund industry remains relatively underdeveloped. By the end of 2006, there were 289 funds,⁷⁴ with total assets of only YTL22 billion (US\$15.4

⁷¹ '[T]he whole mutual fund industry was benchmarked in the CDI, so funds to be compared to other funds, you show your quotas in percentages of CDI, so my fund is performing 105 per cent of CDI. If your fund is performing 104 per cent of CDI my fund is better than yours so I should get more money from the investors than you...A lot of funds, they do not have any incentive to do intelligent things, they just buy a bond from the government to finance the rollover of the debt, and they hedge this in the future market and get these 30 basis points which normally in the past 30 basis points in a CDI of 19 per cent was about 3 per cent of CDI...I get the fees, easy money, no problem, life goes on' (Head of Trading, foreign-owned bank, Brazil, interviewed 4 September 2006); also Head of Sales and Trading, foreign bank, Brazil, interviewed 30 August 2006; trader, foreign bank, Brazil, interviewed 29 August 2006.

⁷² Hedge fund manager, Brazil, interviewed 11 September 2006.

⁷³ Head of trading, foreign-owned bank, Brazil, interviewed 4 September 2006.

⁷⁴ The vast majority of mutual funds in Turkey are open-ended (World Bank 2003: 42).

billion),⁷⁵ although this is nearly eight times pension mutual fund assets at the same date.⁷⁶ Assets were divided as in table 4:

Table 4

Assets of Turkish mutual funds (end 2006)

Number of Investors	Equity (Per Cent)	Public Debt Instruments (Per Cent)	Corporate Bonds (Per Cent)	Reverse Repos (Per Cent)	Money Market Investments (Per Cent)	Foreign Securities (Per Cent)	Other (Per Cent)
2,470,909	2.70	38.27	0	57.53	1.39	0.09	0.02

Source: Capital Markets Board

96 per cent of the mutual funds assets at this date were government bonds or repurchase agreements involving government bonds. Foreign mutual funds are available, but total assets were only US\$55 million.⁷⁷ To an even greater extent than in Brazil, Turkish mutual funds are a direct alternative to bank deposits.⁷⁸ Until the beginning of 2006, mutual funds enjoyed a (now-removed) tax advantage over direct holdings of domestic securities.⁷⁹ The total assets of mutual funds did fall in 2006 (influenced also possibly by the competition for bank deposits discussed previously), but the expectation of interviewees was that an increased ability to exploit fund management skills will replace tax advantages, leading to resumed growth. Increased financialisation will increase the

⁷⁵ Source: Capital Markets Board, Turkey.

www.spk.gov.tr/HaberDuyuru/aylikbulten/2007/Ocak/aylik_istatistik_bulteni_2007_Ocak.xls#V-1-2!A1, accessed 7 May 2007.

⁷⁶ Source: Capital Markets Board, Turkey.

www.spk.gov.tr/HaberDuyuru/aylikbulten/2007/Ocak/aylik_istatistik_bulteni_2007_Ocak.xls#V-2-2!A1, accessed 7 May 2007

⁷⁷ Source: Capital Markets Board, Turkey.

www.spk.gov.tr/HaberDuyuru/aylikbulten/2007/Ocak/aylik_istatistik_bulteni_2007_Ocak.xls#V-3-2!A1, accessed 7 May 2007.

⁷⁸ Economist, foreign bank, Turkey, interviewed 5 December 2005; Manager, investment banking subsidiary, Turkish bank, interviewed 6 December 2005.

⁷⁹ Manager, investment banking subsidiary, Turkish bank, interviewed 6 December 2005.

opportunities for active fund management. However, Turkey demonstrates that the initial emergence of mutual funds in a financial system characterised by low levels of financialisation is likely to result in an increase in government policy autonomy relative to a bank dominated system.⁸⁰ Individual investors choose mutual funds as an alternative to bank deposits, and as a result a higher proportion of individuals' savings flow directly into financing government debt. However, mutual fund investors do not invest as long term as pension funds – in Turkey the maturity of pension fund investments is around twice that of mutual funds.⁸¹ Therefore, mutual fund investment in government debt results in lower government policy autonomy than pension fund investment.

Mutual Funds and Government Policy Autonomy

Mutual funds can be placed at almost any point on the autonomy curve, largely because even the relatively narrow definition of mutual fund used here covers investment in a wide range of assets and markets. Initially, in both Brazil and Turkey, mutual funds develop as a direct alternative to bank deposits, and specialise in shorter maturity government debt. High interest rates on government bonds have an obvious influence on this development, as does the experience (particularly in Brazil but to a lesser extent in Turkey) of a high inflation environment. However, this chapter suggests that it would be wrong to see such crowding out, even when complemented by the influence of investor experience, as a complete explanation of this focus of mutual funds on government debt. While not seeking to dismiss the importance of crowding out or regulation, the experience of mutual funds in Brazil and Turkey shows that a more complete explanation must link the level of financialisation to the degree of loyalty of mutual funds to government debt. In a financial system with a low level of financialisation, mutual funds are likely to invest predominantly in government bonds. Prudential

⁸⁰ The low level of financialisation is important. In the United States, for example, money market funds developed as an alternative to bank deposits, but invested in the already-established commercial paper market, rather than government bonds (Krippner 2007).

⁸¹ Department Head, Turkish Treasury, interviewed 30 November 2005.

regulation may have an influence on this, prompting enforced loyalty, but the other reasons behind investment choices highlighted here are also important.

As financialisation increases (including as a result of the increasing size of the mutual fund industry), the alternatives available to investors increase, and the cost of exiting the government debt market falls. Investors' loyalty to government debt therefore decreases. The development of a mutual fund industry is in itself likely to increase internationalisation, by making the market more attractive to foreign fund managers. By 2002, 46 per cent of Brazilian investment firms were owned by foreign institutions.⁸² The ability of the government to borrow from loyal investors decreases, and therefore its policy autonomy also decreases. The ability of the government to attract a high proportion of the available investment capital by way of high interest rates remains strong, as the experience of both Brazil and Turkey demonstrates, and the long term influence of individual investor experience, as in Brazil, continues to be felt. Nevertheless, increased financialisation increases investor choice, reducing the government's share of investment funds. If government borrowing remains at similar levels relative to the size of the economy, the government will be forced to rely more heavily on high interest rates, with implications for expenditure elsewhere. An alternative is borrowing from abroad, but this decreases government policy autonomy. Mutual funds therefore, as financialisation increases, reduce government policy autonomy, even after initially potentially increasing autonomy.

Hedge Funds

A further increased degree of financialisation is hedge funds. Whereas other institutional investors can be 'loyal' (invest in government bonds) or 'exit' (sell their holdings), hedge funds, in the same way as proprietary traders at banks, have the option to express 'disloyalty'. Taking a short position means that hedge funds continue to care about the market in which they invest, but have an interest in deterioration, rather than simply the

⁸² Source: AltAssets, www.altassets.net/casefor/countries/2002/nz3064.php, accessed 20 July 2006.

indifference post exit. Furthermore, a hedge fund's leverage makes it more influential than a mutual or pension fund with the same amount of investor funds. The use of leverage varies considerably. The now-infamous Long-Term Capital Management's leverage varied from 14:1 to 31:1 (MacKenzie 2003: 355), although, given that over-leverage was one of the reasons given for the firm's collapse (*ibid.*: 352), it is reasonable to assume its ratios were high. One recent survey of international hedge funds found gearing of 1.66 times net equity and noted the fall in leverage after LTCM (*Financial Times* 2 May 2007: 19). The use of leverage has a further influence on investor behaviour. In contrast to 'real money' investors (financial market parlance for investors which do not leverage their investments), hedge funds tend to trade their portfolios actively (Crockett 2007: 20), selling quickly if prices move against them.

Hedge funds may also be short term relative to the other investors that can express disloyalty, bank proprietary trading desks (see chapter 2). Hedge funds almost always employ 'stop losses'. This means that if an individual trade moves against them (i.e., becomes loss-making) by a certain, pre-set amount, that position will be automatically sold, regardless of market conditions or the trader's view on the future direction of the market. Interviewees amongst international hedge fund managers and investment bank traders, undertaken as part of another research project, suggest these formal stop losses are a key difference between hedge funds and bank traders. Investment bank traders do not generally operate such formal stop losses, and so will be prepared to run their positions longer in the event that they show a loss.⁸³ In Brazil, stop losses appear to be applied by both hedge funds and bank proprietary traders,⁸⁴ but the daily reporting and liquidity requirements of the hedge funds (see below) would still be likely to make hedge funds more short term than proprietary traders.⁸⁵

⁸³ Hedge fund manager, London, interviewed 23 June 2005; investment bank trading manager, London, interviewed 17 October 2005.

⁸⁴ Hedge fund manager, Brazil, interviewed 12 September 2006.

⁸⁵ Hedge fund manager, London, interviewed 18 February 2005.

Hedge funds investment mandates tend to allow them a wider choice of investments, including not buying government bonds. In developed countries, '[a]s hedge funds are only lightly regulated, their managers can pursue investment strategies that are not open to mutual fund managers, including for example, heavy use of derivatives, short sales, and leverage' (Bodie *et al.* 2005:111). The term hedge fund was initially used because these institutional investors minimised their exposure to overall market movements, but, although such an investment style is sometimes still assumed (e.g., Bodie *et al.* 2005: 335), the activities of hedge funds are now far broader.⁸⁶ Their investment strategy is still sometimes deemed to be 'to exploit market imperfections' (Crockett 2007: 20). It is questionable whether these investors could be successful without light regulation (*ibid.*: 23; Basel Committee on Banking Supervision 1999: 3), but the greater sophistication of hedge funds means they are better able to exploit loopholes to circumvent regulation. Hedge funds are therefore the least susceptible to a government's use of regulation to increase investment in government debt, whether the increase is the direct intention or an indirect consequence of prudential regulation. Hedge funds are 'absolute return' investors. Their aim is a positive return, regardless of market conditions, rather than outperforming the market. Fees are structured as a small percentage of the total funds managed and a percentage (usually 20 per cent) of the absolute return of the fund. So if the fund makes a return of 10 per cent in the year, the hedge fund itself will be paid 2 per cent (Chadha and Jansen 1998: 34; Brown *et al.* 1999: 92).

Brazilian Hedge Funds

Of the three case study countries, hedge funds (also known as 'multimarket funds') are significant only in Brazil, with more than 50 funds (Crockett 2007: 21). They made up 20 per cent of investment fund assets in 2006 (CVM undated: 34). Unlike in developed countries, Brazilian hedge funds are subject to regulation on their investments, being

⁸⁶ See Eichengreen *et al.* 1998b; Uribe 2006; Crockett 2007: 27 for the different strategies of hedge funds globally.

limited to 10 per cent of net assets invested abroad under Rule 409.⁸⁷ However, it appears likely that sophisticated hedge fund investors can get around such restrictions to some degree, for example by using total return swaps (although it is more expensive than direct investment).⁸⁸ There are significant constraints on hedge fund activity, however, from the ‘CDI culture’ discussed extensively above. Hedge funds globally have traditionally operated with a ‘lock up’ on investments; an investor must commit funds for a pre-determined period of time before they can redeem, or exit. This can be a significant time. In the case of Long-Term Capital Management, investors could not withdraw money for 3 years (MacKenzie 2003: 363). The main reason is to prevent withdrawals of funds that force the liquidation of positions before they become profitable (Shleifer and Vishny 1997). While the 3 years of LTCM is exceptional, lock ups are usual for hedge funds in developed countries (Crockett 2007: 20), and the contrast with Brazil is dramatic. In Brazil, most hedge funds have had to follow the mutual funds in offering *daily* liquidity. With the exception of those hedge funds started by managers with particularly strong established reputations, investors are able to withdraw funds whenever they wish. By one interviewee’s estimate, this applies to 90 per cent of hedge funds.⁸⁹ This creates significant difficulties:

[W]e are compared among ourselves with our peers on a daily basis. So if we are not performing in the local markets and if we are in fact losing money, and as there is no lock up and I can move my money from this fund to your fund, the withdrawals can push the fund to realise even more losses immediately because there is no lock up. So they start to have money...getting out, so you have to liquidate positions to deliver the money, and then you accelerate the losses and the market moves much faster because the hedge funds are liquidating positions.⁹⁰

⁸⁷ www.cvm.gov.br/ingl/indexing.asp, accessed 2 May 2007.

⁸⁸ ‘[T]hey cannot send money abroad but through derivatives I can do it for them, so I can buy through my parent company, do a kind of derivatives and pass these derivatives to these guys. So it’s possible to have the risk’ (Head of Sales and Trading, foreign bank, Brazil, interviewed 30 August 2006). ‘In a total return swap...an investor...enters into a derivatives contract whereby it will receive all the cash flows associated with a given reference asset or financial index without actually buying or owning the asset or the index’ (Bomfim 2005: 83).

⁸⁹ Head of Trading, foreign-owned bank, Brazil, interviewed 4 September 2006.

⁹⁰ *Ibid.*

As a result, '[y]ou see funds [dropping] from 1 billion Reals to 100 million Reals in a month'.⁹¹ A number of the hedge funds manage separate funds, both investing in Brazil, one for Brazilian investors, one for foreigners. The requirement for higher liquidity means they will take less risk in the fund for Brazilians,⁹² and that 'market timing becomes much more of an issue in one fund than in the other'.⁹³ The banks representing wealthy individuals will effectively 'trade' funds.⁹⁴ The result is 'I can't allow myself to lose a lot of money two days in a row because I know my clients are going to move'.⁹⁵ A fund manager whose reputation allows a 90 day lock-up considers daily liquidity 'unimaginable' and considers his fund can take more risk simply because of the lock-up.⁹⁶ The daily liquidity also serves to exacerbate herding, particularly selling.⁹⁷ Lastly, a fund with no lock up must keep sufficient liquidity to meet any redemptions (Crockett 2007: 20), reducing the amount that can be utilised in the chosen investment strategy.

The issue of hedge funds having to offer daily liquidity (and the contrast between hedge funds and banks proprietary traders above) can clearly be seen in one of two ways. Either the requirement for daily liquidity forces selling in the event of a weak market, or it limits risk taking by hedge funds, so reducing financialisation by limiting the ability to trade risk. Both are clearly true at different times. However, the possibility of daily withdrawals of investor funds is known by hedge fund managers, as is the possibility of market weakness. Therefore, the more important implication of daily liquidity is to reduce the activities of hedge funds, through reduced levels of leverage and/or smaller

⁹¹ Head of Trading, foreign-owned bank, Brazil, interviewed 4 September 2006.

⁹² Hedge fund manager, Brazil, interviewed 12 September 2006; hedge fund manager, Brazil, interviewed 11 September 2006; trader, foreign bank, Brazil, interviewed 29 August 2006.

⁹³ Hedge fund manager, Brazil, interviewed 11 September 2006.

⁹⁴ 'For instance, suppose [bank managing money for wealthy individuals] call me, what's your view of the central bank decision?...What they do, they take some money out if they disagree with our decision, I don't know...why are you paying me to trade your money if you are willing to trade what I trade?' (Brazilian hedge fund manager, interviewed 12 September 2006).

⁹⁵ Brazilian hedge fund manager, interviewed 12 September 2006. 'Most of the fund managers are really looking at giving a steady and constant return to their investors so that they don't migrate from one fund to another' (Head of Trading, foreign-owned bank, Brazil, interviewed 4 September 2006).

⁹⁶ Brazilian hedge fund manager, interviewed 31 August 2006.

⁹⁷ Senior official, Ministry of Finance, Brazil, interviewed 6 September 2006; Head of Trading, foreign-owned bank, Brazil, interviewed 4 September 2006.

stop losses, and therefore their influence in the market relative to other market actors. Brazilian hedge funds will be less able to contribute to the ‘completeness’ of the market (Crockett 2007: 22). The requirement for daily liquidity is likely to keep a higher proportion of hedge fund assets in liquid government bonds, so a high level of investment concentrated in financing a government can be seen as itself a market anomaly that a more ‘complete’ market would reduce.

Linked to the issue of daily liquidity is the need to perform relative to the high-yielding CDI. Hedge funds face the same challenge as other institutional investors, in that their potential clients can achieve high real returns with minimal risk, and so are less inclined to invest in hedge funds.⁹⁸ The high interest rates also make short selling expensive, thereby limiting activity.⁹⁹ Disloyalty can also be crowded out. Fees are paid for outperforming the CDI, not on the absolute return, as is more common internationally. This has a significant impact on potential profitability. As a result, if the CDI is, for example, 15 per cent, a Brazilian hedge fund with an investment return of 20 per cent will earn the same as an international hedge fund with a return of 5 per cent.¹⁰⁰ Brazilian hedge funds are also small relative to their international counterparts, with the implications for the costs of information gathering already discussed.

The hedge fund industry therefore remains relatively underdeveloped compared to hedge funds in developed countries (although far ahead of other emerging market countries), and has significantly higher constraints on investment activity. Yet the dominant point to be made about Brazilian hedge funds is the similarities with international hedge funds, rather than the differences. Both Brazilian and international hedge funds share the characteristics of leverage, the ability to short, the greater sophistication, and the short-

⁹⁸ Hedge fund manager, Brazil, interviewed 11 September 2006; hedge fund manager, Brazil, interviewed 31 August 2006; hedge fund manager, Brazil, interviewed 11 September 2006.

⁹⁹ Head of Trading, foreign-owned bank, Brazil, interviewed 4 September 2006.

¹⁰⁰ Proprietary trader, Brazilian bank, interviewed 29 August 2006; Head of Trading, foreign-owned bank, Brazil, interviewed 4 September 2006; hedge fund manager, Brazil, interviewed 12 September 2006; hedge fund manager, Brazil, interviewed 11 September 2006; trader, foreign bank, Brazil, interviewed 29 August 2006; hedge fund manager, Brazil, interviewed 31 August 2006.

term trading strategies. They also have a generally wider investment mandate than other institutional investors. Many of the managers come from bank proprietary trading desks, including those of foreign banks.¹⁰¹ Some worked previously for international hedge funds, most famously Arminio Fraga, who worked for Soros, moved to become Governor of the Banco Central do Brasil, and in 2003 founded the Brazilian hedge fund, Gávea Investimentos. A number of Brazilian hedge funds operate global funds, rather than just specialising in Brazilian assets.¹⁰² Comparing with international hedge funds, the consensus amongst Brazilian interviewees can be summed up as ‘There are slight differences but nothing really fundamental’.¹⁰³ Importantly, also, the Brazilian hedge funds are moving to become even more similar, driven by falling interest rates making investors generally more willing to take risks,¹⁰⁴ and the increased track record of hedge funds meaning longer lock-up periods become accepted.¹⁰⁵

Hedge Funds and Government Policy Autonomy

Hedge funds represent the (possibly current) extreme of financialisation in government debt markets, and reduce government policy autonomy the most. They sit towards the right hand end of the autonomy curve. They are therefore at the forefront of the debate regarding government policy autonomy. Hedge funds are more short term traders, whose use of leverage both increases their influence and requires the ‘stop-loss’ related selling at times of market weakness. Their ability to short, to express disloyalty, means they can be seen as either contributing to market weakness or as helping ‘ensure that all relevant information is fully and quickly reflected in market prices’ (Crockett 2007: 22).

Performance measurement based on absolute, rather than relative, returns, provides

¹⁰¹ Head of Sales and Trading, foreign bank, Brazil, interviewed 30 August 2006; hedge fund manager, Brazil, interviewed 11 September 2006.

¹⁰² Hedge fund manager, Brazil, interviewed 11 September 2006.

¹⁰³ Hedge fund manager, Brazil, interviewed 11 September 2006; also hedge fund manager, Brazil, interviewed 12 September 2006; Head of Sales and Trading, foreign bank, Brazil, interviewed 30 August 2006; emerging market debt trader, New York, interviewed 18 May 2006.

¹⁰⁴ Head of Products and Services, foreign bank, Brazil, interviewed 30 August 2006.

¹⁰⁵ Head of Sales and Trading, foreign bank, Brazil, interviewed 30 August 2006; Head of Trading, foreign-owned bank, Brazil, interviewed 4 September 2006; hedge fund manager, Brazil, interviewed 12 September 2006.

greater incentive to take short positions. Hedge funds generally have the most sophisticated investment strategies and broadest investment mandates, giving a greater ability to invest in assets other than government bonds, and the greatest ability to circumvent regulations legally. Hedge funds both benefit from, and contribute to, the greater financialisation of government bond markets.

Hedge funds, as active traders, add liquidity to the market (Crockett 2007: 22), although, as has been demonstrated, increased liquidity also serves to decrease the cost of exit, and therefore loyalty. However, as will be discussed in the next chapter, hedge funds can allow governments to issue bonds about which domestic investors are wary; Brazilian inflation-linked bonds are an example. Brazilian hedge funds are the investors within Brazil whose activities most closely match those of their international counterparts. The issues surrounding hedge funds will therefore be considered more fully in the next chapter, on international investors, and in the concluding chapter.

Conclusion

This chapter has considered three different types of institutional investors – pension funds, mutual funds and hedge funds, and sought to analyse the influence of each on the autonomy of government policy from the preferences of international investors. The central conclusions are:

The initial phase of institutionalisation, through pension funds and/or mutual funds, is dominated by investment in government debt, for reasons linked not only to prudential regulation, but investor choice. In the case of mutual funds in particular, this investment is as an alternative for individuals to bank deposits. It therefore represents an increase relative to banks in the ability of the government to finance itself without recourse to international investors or less loyal domestic investors. In this early phase of financialisation, therefore, government policy autonomy increases. Pension funds, as

natural 'buy and hold' investors in long term debt, serve to increase autonomy to a greater (though variable) extent than mutual funds.

As financialisation increases, the ability of the government to dominate investor flows while still relying on loyal investors decreases, and autonomy therefore also decreases. Hedge funds represent, in the current financial markets, the institutional culmination of this process, as they are the least loyal, and have the further ability to be 'disloyal'. A government debt market dominated by hedge funds, therefore, will see the lowest level of government policy autonomy.

No financial market has developed to the extent that all autonomy is removed and a government must follow completely the preferences of international investors, primarily because, for reasons explored above, of home bias. Even Brazilian hedge funds are Brazilian, and primarily serve investors who have the same home bias as investors elsewhere. Brazilian hedge funds are still also more easily regulated than their international counterparts. However, the degree of the government's autonomy will be influenced by which institutional investors are predominant in the government bond market (relative to each other, and relative to the other financial actors – individuals, commercial banks and international investors) and by the nature of those institutional investors, particularly their opportunities to diversify their investments away from government debt. If those opportunities are widespread, the government must rely on traditional 'crowding out' through high interest rates, and must rely to a greater extent on international investors, internationalising their financing and thereby reducing their autonomy from the preferences of those international investors. The next chapter will deal with these international investors.

Chapter 5

International Investors

Introduction

This chapter now moves discussion to the area that international political economy has long considered of central importance: international portfolio capital. As discussed in previous chapters, the role of international investors in the international debt of the case study countries is overstated, if still, in Brazil and Turkey, highly significant. In the domestic bond markets, international investor involvement remains relatively low. In Brazil, foreign participation is just over 2 percent of the domestic debt market,¹ and in Lebanon even lower. In Turkey, non-residents owned 18 per cent as of October 2006 (see Appendix B, Table 4). With the exception of Lebanon, however, these figures are growing rapidly, and in certain areas of the markets, international investors are far more important. This will be discussed further below.

One of the important existing debates concerns the relative importance of push (international market conditions) versus pull (economic and political conditions in the recipient country) factors in international capital flows. This chapter seeks to expand on considerations of push versus pull factors. Maxfield (1998b) considers differences between impatient and patient investors, and the sensitivity of different investor types to push or pull factors. This chapter takes a similar approach. The more short-term, impatient, the investors, the lower their level of loyalty, and the greater the policy constraint they impose on governments. The ability to express disloyalty by short selling government bonds constrains still further. Alternatively, if capital is patient, it is less

¹ www.tesouro.fazenda.gov.br/divida_publica/downloads/SP_Nov06.pdf, p.43, accessed 4 January 2007.

constraining, even if it is international. This is all the result of the financialisation of the investors themselves.

An occasionally significant group of international investors have not been considered in this research, but should nevertheless be briefly recognised. This is individuals, primarily in Europe. The governments of both Brazil and Turkey have benefited from demand from European individual investors, especially when issuing bonds in European currencies. Their role came to prominence as a result of the Argentine debt default: 'About 400,000...Italians...together with other individuals, most in Europe and Japan...ended up holding \$24 billion in claims on the bankrupt Argentine government' (Blustein 2005: 74). As the experience of the Argentine default shows, especially when compared to the reaction of institutional investors, individual investors appear to represent the lowest level of financialisation amongst international investors, and the lowest constraint on government policy autonomy (see also chapter 3). International individuals, nevertheless, by dint of their greater investment choices, represent, relative to domestic individual investors, greater levels of financialisation and more constrained government policy autonomy.

The types of international investors that enter a particular government bond market, and the order in which they do so, varies considerably. Low levels of financialisation in a market such as Lebanon will deter more trading-oriented investors such as hedge funds, and any investment is likely to be from more long-term investors. However, once a certain level of financialisation has been reached, such as in Turkey, the earliest entries are those whose investment mandates are broad enough to allow this activity. In Turkey, this meant that hedge funds and international bank proprietary trading desks were the first entrants, followed only later by longer term investors such as pension funds.² In Brazil, the existence of controls on capital inflows gave an advantage to those market actors able to circumvent the controls.

² Head of Trading, foreign bank, Turkey, interviewed 5 December 2005; Head of Treasury, Turkish bank, interviewed 7 December 2005.

In a situation where longer term international investors enter a government bond market, in addition to hedge funds remaining, internationalisation is clearly increased. Whether financialisation is similarly increased depends on the nature of the investors whose investment is reduced as a result of the new entrants. If longer-term international investors replace domestic banks, individuals, mutual funds and/or pension funds, financialisation may increase. Financialisation would certainly increase if domestic mutual funds and pension funds are less financialised than the international entrants, as is the case in Brazil and Turkey. If more patient international investors replace hedge funds, domestic or international, financialisation will decrease, and government policy autonomy will increase. Movement on the autonomy curve does not have to be in one direction, therefore, from left to right (see chapter 6). If international hedge funds enter the market first, they will reduce government policy autonomy as a result not only of their policy preferences, but also because of their short term trading – speeding the market reaction to policies and events (Crockett 2007: 23) – and their use of leverage. The subsequent entry of more long term international investors could increase or decrease government policy autonomy, depending who they replace (and assuming an unchanged level of government borrowing).

Just as is the case for domestic investors, and as discussed in the previous three chapters, different foreign investor types demonstrate different degrees of loyalty. To argue that loyalty can exist amongst international investors is not to argue that it is likely to be as strong as for domestic investors. Investment in any emerging market country is always likely, except in exceptional circumstances, to be a small part of a total portfolio for international investors, and those investors already have substantial alternatives. Only very rarely could international investors be ‘quality-makers’. Nevertheless, there are issues of loyalty with different types of international investors: individual investors are generally buy and hold investors who face high transaction costs; pension funds, just as their domestic counterparts, are long term investors; and those funds measured against a market benchmark have to consider how far they can be ‘underweight’ a country relative

to its index weighting. For all investors, there is also the question of what financial instruments (bonds, credit default swaps, futures, etc.) they are able to utilise.

Chapter Structure

The chapter concentrates on a number of factors influencing the level of international investor interest in a government bond market. The existing literature on push versus pull factors will be considered, and the influence on this debate of the data collected for this study. This will focus in particular on the debate regarding capital controls, and on the importance of transaction costs. The chapter will then consider a number of push factors not commonly considered in the existing literature. Questions of investment mandates, the internal controls that control investment behaviour, will be analysed, including how their performance is measured. It will be suggested that investment mandates have a significant impact on where international institutional investors choose to invest, and in the loyalty (or disloyalty) they display towards an individual country. A particular distinction is drawn between ‘index-benchmarking’ and ‘total return’ investors, but differences between long and short term investors (largely supporting Maxfield’s conclusions) are also considered. Importantly, the way in which investment mandates are changing, increasing financialisation, will be discussed. The role of international investment banks in reducing transaction costs is then analysed, as an important part of encouraging entry by international investors, and therefore internationalisation. Lastly, the chapter considers some of the results of increased internationalisation for government policy autonomy.

Factors Influencing International Investor Interest

Push versus Pull Factors

Much of the consideration of the factors that influence international investor interest in emerging markets has focused on the relative importance of ‘push’ versus ‘pull’ factors

(e.g., Eichengreen and Mody 2000). If international investor interest in financing an emerging market government is primarily the result of ‘push’ factors such as U.S. interest rates, rather than ‘pull’ factors such as the policies of the government seeking financing, then it is clear that the impact of government policy choices is reduced, and governments effectively have greater autonomy. In periods of abundant (constrained) global liquidity, governments will find financing relatively plentiful (limited), regardless of their policy choices. There is no consensus on the relative importance of these influences on portfolio capital flows. Mosley (2003:151) concludes that in normal market conditions national economic and political fundamentals drive investor decisions, with global sentiment only dominant in manias or panics. Chohan *et al.* (cited by Eichengreen and Fishlow 1998:49) conclude push factors explain only about half of the variation in bond and equity flows from the US to six Latin American countries; Manzocchi (2001:61) concludes they account for no more than 30-50 per cent. Eichengreen and Rose (1998) see emerging market crises as the result of both pull (particularly slow output growth and an overvalued exchange rate) and push (rising international interest rates) factors.³

Other views see international factors as a more dominant influence. This is not necessarily to the disadvantage of the borrowing country. In Brazil in the 1990s, international capital appears to have ignored what would be expected to be regarded as poor policy performance (Kingstone 1999: 136; Sachs 1989a: 6 argues the same for bank lending before 1982). However, there is also a malign view of the impact of investor ignorance. Looking at the influence of the increased cost of information gathering in a diversified portfolio, Calvo (1996; see also Calvo and Mendoza 2000a) finds that diversification lowers investors’ incentives to learn about individual countries, with the resultant ignorance meaning ‘frivolous rumors’ potentially prompt massive capital flows. Maxfield (1998b:71) concludes that ‘capital flows to emerging market countries do not respond to information about changes in host country economic policy or prospects for political stability’. She also sees the potential influence of ‘rumor or

³ They recognize the Asian crisis does not fit this conclusion well (*ibid.*: 29).

technical factors unrelated to factual events in the country', with short term investors making a country more susceptible to exogenous influences (*ibid.*: 73). Calvo *et al.* (1996: 217; also Armijo 2001b) conclude 'global factors, like cyclical movements in interest rates, were especially important' for portfolio flows. Fernández-Arias (cited by Maxfield 1998b: 79) concludes that international interest rates can explain fully 86 per cent of the change in capital inflows for a typical developing country. Looking specifically at emerging market bonds, Eichengreen and Mody (2000:130) found similarly that 'changes in market sentiment not obviously related to fundamentals have moved the market by large amounts over short periods'. Fernández-Arias and Rigobobón (2000:37) find '[t]he co-movement of prices and spreads [of emerging market bonds] is remarkable' and '[i]t is extremely difficult to reconcile the...evidence with the notion that spreads reflect economic fundamentals underlying the countries' risk of default' (*ibid.*:38).

This thesis does not seek in any way to disagree with the importance of, or take a view on, the debate regarding the relative influence of push and pull factors. Both are dealt with within the idea presented here of an autonomy curve, as factors that influence the height of the whole curve on the y axis of the graph (see chapter 6). The focus here is also not on the traditional pull factors of neoliberal economic policy, such as reduced fiscal deficits and low inflation, or on push factors such as the level of developed world interest rates. The pull factors discussed here are related to level of financialisation in the government debt market, and the push factors to the financialisation of the investors themselves. The argument presented here concerns the inter-relationship between push and pull factors: the single pull factor of the level of financialisation in the government bond market has an influence on, and is in turn influenced by, the level of financialisation of international investors (a push factor).

Declining Effectiveness of Capital Controls

One of the most often-mentioned areas of neoliberal policy preference is liberalisation. Two factors can be seen as influencing where international investors choose to invest: where they are allowed to (i.e., liberalisation), and where they want to. A focus on the first factor (liberalisation) can lead to the second being underemphasised, even though liberalisation remains an important part of increased financialisation. The question of where international investors are allowed to invest is obviously tied to the question of controls on capital flows which has formed a part of the debate on reform of the international financial architecture following the Asian crisis (e.g., Eichengreen 1999). It is not the intention of this thesis to focus extensively on this question, except for two points. The first is to reemphasise that the liberalisation of international financial flows (just as its domestic equivalent, letting capital out of the country) is an aspect of financialisation, in that it makes the trading of risk easier.

The second point is that in an increasingly financialised international system, capital controls are becoming easier to bypass (Goodman and Pauly 1993; Cerny 2001: 19; Prasad *et al.* 2004: 3; on Brazil, Carvalho and Garcia 2006; see chapter 1 for further discussion). In the case study countries considered here, it would be more accurate to see the liberalising of inward capital flows as reducing the cost of entry into the market for international investors, rather than allowing it. An example of this is the Brazilian domestic market. Various regulations made entry expensive prior to February 2006, but it was possible for many investors to enter nevertheless, with those regulatory difficulties reduced in their minds to ‘its constraints are just that we’re paying 25, 50 cents [0.25 – 0.50 per cent] a fee for a credit-linked note’.⁴ An alternative would be a total return swap (see Chapter 4, Note 88), another structure which requires derivatives (see also Carvalho and Garcia 2006).⁵ This is despite the not inconsiderable difficulties

⁴ Bank proprietary trader, New York, interviewed 15 May 2006. ‘Credit-linked notes are essentially securities structured to mimic closely...the cash flows of a credit derivative’ (Bomfim 2005: 123).

⁵ Emerging market debt trader, New York, interviewed 18 May 2006.

of investing in Brazil directly.⁶ Domestic Brazilian interest rates also trade actively 'offshore'.⁷ In Turkey, investors unable to buy Turkish government bonds directly can buy Eurolira bonds, the structuring of which again requires derivatives, in this case a swap transaction (for details, see Hardie and Mosley 2007). One interviewee divides local markets into three categories:

[I]n the first category you just invest in the country, in the second country there is cost but you have the option of either doing it yourself and incurring a time cost, or whatever monetary cost, but in the third case you don't have the options. If you want to be in a country with capital restrictions you have to go through a bank which has a local office.⁸

All this serves, in a very direct way, to undermine government policy autonomy by undermining the ability to regulate, provided investor interest is sufficient to provide the incentives for this activity to develop, and domestic intermediaries facilitate it. In Brazil domestic intermediaries do facilitate these activities; in Lebanon they do not (see chapter 2).

These observations suggest two points of relevance to the debate regarding capital controls. First, the decline in the effectiveness of capital controls is linked to the level of financialisation of the structure of government bond markets, and of the actors, domestic and international, within the markets. Governments with bond markets with a high level of financialisation are able to do little more than impose small additional costs (including through taxation⁹) on inflows. Questions of liberalisation of capital flows should therefore be about questions of financialisation in total, not just the regulation of international inflows. Second, and obviously, without interest from international

⁶ 'If you want to buy a local currency bond in Brazil, in a tax-efficient way, it will take you six months to set up a structure, lawyers...this is infrastructurally difficult, when you're going into local currency stuff... you've got a lot of legal documentation and operational stuff. You've got a lot of risks out there, from an operational point of view' (strategist, fund management company, London, interviewed 14 February 2006).

⁷ Strategist, investment bank, London, interviewed 5 January 2005.

⁸ Fund Manager, insurance company, London, interviewed 14 February 2006.

⁹ Fund manager, London, interviewed 16 February 2006.

investors, neither liberalisation nor the willingness of financial intermediaries to assist in market access will make a huge difference to the involvement of international investors.¹⁰ A focus on the liberalisation of capital inflows therefore misses an important part of the overall question. The role of financialisation in generating that investor interest will now be explored.

Importance of Transaction Costs

The best way to summarise international interviewees'¹¹ attitudes to investing in a particular country is that they want to be paid for their time. The available returns from interest rates and/or currency appreciation must be sufficient to overcome transaction costs, including, most importantly, the costs of information. It must also be possible to invest in sufficient size to have a meaningful impact on the overall return on an investor's portfolio, and there must be sufficient financial instruments acceptable under the fund's investment mandate (which sets out what investment activities the fund will engage in) to allow profitable investment. For certain investors, most importantly hedge funds, this includes the ability to take short positions (see chapter 4). For all investors, consideration must also be given to the ability to exit their investment, even if, for a 'buy and hold' investor, this is only an estimation of the probability of being repaid on the maturity of the investment.

The idea of needing to be paid for one's time matches very closely Calvo (1996) and Calvo and Mendoza's (2000a) analysis regarding the impact of information costs on contagion, particularly the way that an increasingly diversified portfolio (and an inability to take short positions) reduces the incentive to gather information, as each investment

¹⁰ '[T]o...allow a swap market in the legislation is just one step. If banks do not want to enter into a swap agreement there is no swap market. Cases are Peru, for example...Colombia...and it's very important because when you have a swap market you can choose instead of receiving fixed, if you think interest rates are going higher you decide to pay fixed. It is a way to go short' (hedge fund analyst, New York, interviewed 15 May 2006).

¹¹ In both Brazil and Turkey, interviews were conducted with investors who bought bonds issued by other emerging market countries. For the purpose of this chapter, their observations are included. However, the particularities of their situation, discussed previously, obviously still apply.

has a limited impact on the overall portfolio. International investors are faced with an effectively limitless amount of information, and must choose where to spend their time (Simon 1955, Abolafia 1996, Odell 2002). For Calvo and Mendoza, the reaction of investors is to choose to follow the market if the costs of independent information gathering are too high. The data presented below suggest this may be the reaction of some investors, especially in high interest rate countries (which would include those, as analysed by Calvo and Mendoza, in crisis), but for many investors, where the opportunities are limited, an equally likely response is to ignore a country altogether.

The universe of potential countries in which to invest is reasonably large. In the case of probably the largest investor interviewed, the portfolio would usually contain around 35 different countries,¹² a similar number to the JP Morgan Emerging Market Bond Indices used by many investors (JP Morgan 2004; see Appendix A). One investor interviewed invested in 65 countries, but considered such a number to be very high compared to other investors.¹³ Clearly, within that, the portfolio would not be divided equally amongst the countries, and many investors would have fewer even than 35 countries in their portfolios. The decision making on what countries to prioritise is important to understanding the extent of, and factors behind, internationalisation. It must first be recognised that, in government debt markets, relatively high interest rates play an important part in attracting the interest of international investors. The experience of the international investor reaction to political scandal in Brazil in 2005, already discussed, is indicative of this. Domestic investors became very concerned by the corruption scandal, but missed the fact that international investors were comparing Brazilian domestic yields with those prevailing internationally, and as a result kept buying.¹⁴ Over the course of the research discussed here, Brazil and Turkey had some of the highest domestic interest

¹² Head of Research, fund management company, London, interviewed 14 February 2006.

¹³ Fund manager, London, interviewed 18 October 2005.

¹⁴ '[T]hey [local investors] just couldn't understand why Joe Greencoat [i.e., foreign investors] just kept buying and buying. They were saying, are these guys crazy? Look what's happening. And it's like no,... you're missing the point, this is a global liquidity story' (fund manager, London, interviewed 21 October 2005). Also proprietary trader, Brazilian bank, interviewed 29 August 2006; hedge fund manager, Brazil, interviewed 31 August 2006.

rates in emerging markets.¹⁵ This thesis, however, is interested in the ways that factors other than high interest rates serve to influence investment, particularly how they might engender loyalty, because the requirement to pay high interest rates is an indication of constrained government policy autonomy. As in other chapters, a key part is played by performance measurement: under what criteria are international investors measured?

Performance Measurement

Fund managers can be divided, very broadly speaking, into those investors who explicitly target, through their fund mandates, performance relative to an index, and those who target absolute return, the percentage increase in the value of the portfolio. Absolute return investors are overwhelmingly hedge funds, and the two terms will be used largely interchangeably in this chapter. Index-benchmarking investors will be considered first.

Investors Measured Against an Index

As already discussed, the main measure of market performance is the various indices published by JP Morgan (for further discussion, see Santiso 2003). Bond indices work by giving a specific weighting to particular bond issues from countries which are part of the index, with the individual bond issues chosen according to a variety of criteria, including a minimum size to maintain liquidity. This has a number of important implications. Since weighting in the index is determined by the number of appropriate bond issues outstanding, it is determined by the size of the particular country's economy, its level of debt-to-GDP, and the choice of borrowing options chosen. On the last of these, if, for example, an EU-aspirant country such as, until recently, Romania, chooses to issue only bonds dominated in euros, Romania will not have any weighting in the US\$ based EMBIs, the most important. This was indeed the case for Romania as of February 2004 (JP Morgan 2004: 3; see Appendix A for a full list of constituents and

¹⁵ Head of Research, fund management company, London, interviewed 14 February 2006.

their weightings). Even more striking, the main indices include Brady bonds, the bonds issued as part of the resolution of the 1980s debt crisis. As a result, countries which defaulted on their bank debt, such as Venezuela and the Philippines, have had a higher weighting than they would otherwise. It is clear, therefore, that the interest of index-benchmarking investors, and therefore the likely level of internationalisation, can be influenced by factors other than simply a country's decision to borrow internationally.

For a fund manager whose performance is – to an extent that varies widely across funds – being measured relative to the performance of the index,¹⁶ the question is what impact investment in a particular country will have on the fund's overall performance relative to the index. With the fund manager's ultimate aim being to keep investors in the fund content, and to attract new investors, it matters that 'if the index is down 12 per cent and we're down 7, they [investors in the fund] will generally be delighted'.¹⁷ Index-benchmarked funds generate their returns by being 'overweight' or 'underweight' in their holdings relative to the index weighting. If a country is 10 per cent of the index, a bullish investor might hold 15 per cent of his portfolio in bonds issued by that country (being 5 per cent overweight); a bearish investor might hold only 5 per cent, and be 5 per cent underweight. Index-related investment has a number of implications, the first of which is regarding the decision regarding the countries worth spending time on.

In deciding where to focus, the first assessment is simply the country's relative weighting in the index: 'in my experience anything below 3 per cent, people are happy to ignore it'.¹⁸ Another fund manager suggested 2 per cent as the level,¹⁹ a large fund 0.5 per cent.²⁰ As of February 2004, using the JP Morgan EMBI Global index, 22 of the 31 countries in the index were below a 3 per cent weighting, and 21 were below 2 per cent. Even a 0.5 per cent threshold excludes 7 constituents. Of the case study countries,

¹⁶ These investors are not passive, index tracking investors, such as are common in equity investment, but are actively seeking to outperform the index.

¹⁷ Fund manager, London, interviewed 16 February 2006.

¹⁸ Fund manager, London, interviewed 15 February 2006.

¹⁹ Fund manager, London, interviewed 21 October 2005.

²⁰ Economist, fund management company, New York, interviewed 31 May 2006.

Lebanon has an index weighting of only 1.12 per cent, with Turkey 6.22 per cent, the fourth largest. It is immediately apparent that the index is extremely concentrated, with Brazil (the largest constituent at 19.01 per cent), Mexico and Russia over half the weighting (see also Santiso 2003: 76). In simple terms, if a country is 10 per cent of the index, the decision as to how much to own has to be taken, even if the decision is to own zero, because that decision will have a substantial impact on relative performance. If a country is 1 per cent of the index, the decision is not as important. Furthermore, the opportunities for a fund that cannot short securities (a usual restriction for index funds) are far lower when a country is a small percentage of the index. If a country is a small part of the index, and the minimum holding is zero, then it is not possible to be very underweight, limiting the opportunities to exploit a negative view and achieve a return for the costs of information gathering (a similar point is made regarding actual short selling by Calvo and Mendoza 2000a).²¹

Such a simple rule of thumb as percentage of the index, while telling something of the decision-making of index following investors, is far from a complete picture of the process. Different assets have different performance characteristics relative to the index. This can be measured by the asset's *beta*. 'Beta measures the extent to which returns on the stock and the market move together' (Bodie *et al.* 2005: 283). High beta bonds cannot be ignored, as this will have an influence on performance.²² An example is Ecuador.²³ Both Brazil and Turkey have historically been high beta assets, although Brazil's repurchase of its international debt and Turkey's EU convergence²⁴ have reduced this. Lebanon is a low beta country, or even has a negative beta, moving in the opposite direction to the market as a whole. In a rising market, performance will be enhanced by a portfolio that is overweight high beta assets, in a weak market, low beta

²¹ Economist, fund management company, New York, interviewed 31 May 2006.

²² Beta is frequently supplanted by the use of 'spread duration', which allows for the greater volatility of longer maturity bonds (fund manager, London, interviewed 15 February 2006).

²³ 'Ecuador is a classic example which is it's the highest beta country in the index and...it can contribute massively to the index return but it's only 2.5 per cent [of the index]. So you would never ignore Ecuador' (fund manager, London, interviewed 15 February 2006); also fund manager, London, interviewed 21 October 2005.

²⁴ Fund manager, London, interviewed 15 February 2006.

assets should similarly result in outperformance.²⁵ Relatively high-yielding countries are also less likely to be ignored, even when they are a smaller part of the index.²⁶ This is particularly the case when market yields generally are high, because the return from the yield of the bond will be high, even if the price of the bonds does not rise.²⁷ There is also less of an imperative to invest in low yielding countries, because investors can be confident in a rising market that these bonds are unlikely to outperform significantly their relevant index.²⁸ Mexico is an example cited.²⁹ Lebanon has, on occasions, also fallen into this category, but the predominant attitude of international investors is that the yield available, thanks to domestic demand, is too low relative to a cursory examination of the economic fundamentals, particularly the extremely high debt-to-GDP level:³⁰ ‘we will not buy this credit because it should yield more’.³¹

Countries which are a small component of the index will see less interest from international investors who are measured relative to that index and so are likely to see slower financialisation. This is not the same as concluding that countries which borrow less from international markets will internationalise more slowly. This is undoubtedly true, but the way in which the various indices are compiled also have a significant impact, independent of the level of a particular countries borrowing. This is demonstrated by the comparison in Appendix A between the percentage of the EMBI

²⁵ Fund manager, London, interviewed 15 February 2006; economist, fund management company, New York, interviewed 31 May 2006.

²⁶ These two points are connected by the fact that high beta countries are also likely to be high yielding.

²⁷ ‘We had something similar happening with the Ivory Coast a couple of years ago, very small credits because they are the high yielder, and...back in the day when emerging markets moved 20 per cent in a couple of months then it’s dangerous to have zero weight. So generally the assumption would be if a credit is a high yielder, and is only say 2, 3, 4 per cent of the index we would generally be much closer to the market weight... when something is a high yielding credit, and that yield is 12 per cent, every month you take in 1 per cent, just by owning that position’ (fund manager, London, interviewed 16 February 2006).

²⁸ ‘I think Malaysia’s official weighting in EMBI global diversified is 5 per cent, but...it’s a country where the spread is so minimal, you can pretty much ignore it. It’s just...a place to hide money if you’re not feeling that great about the market’ (fund manager, London, interviewed 21 October 2005).

²⁹ Fund manager, London, interviewed 21 October 2005. Mexico, as an investment grade rated country, has benefited from demand for its bonds from non-emerging market investors.

³⁰ Proprietary trader, New York, interviewed 15 May 2006; fund manager, London, interviewed 3 February 2006; fund manager, London, interviewed 21 October 2005; hedge fund manager, London, interviewed 18 February 2005.

³¹ Fund manager, London, interviewed 16 February 2006.

represented by each country and the external debt to Gross National Income³² of that country. The three largest EMBI components, and therefore the countries in which index-benchmarked investors have the most interest, have ratios of 22.2 – 30.7 per cent. Lebanon, at 104.4 per cent, has the highest figure, but also has a relatively low level of internationalisation. It also suggests that a small economy will see less interest from this group of investors and will therefore internationalise and financialise more slowly (see also Ghosh and Wolf 2000; Savastano 2000 for discussion of the influence of location).

At the other extreme are countries that are a large part of the index. In these cases, index-benchmarked investment has a different impact, effectively prompting loyalty. This is the result of limitations, in the investment strategies of the funds, on how far ‘off index’ the fund will be. This varies considerably across funds, but 10 per cent appears a common maximum,³³ although in exceptional circumstances, this would increase. In other words, if a country composes 15 per cent of the index, a fund’s portfolio would have between 5 and 25 per cent of its assets in that country’s bonds. For one fund interviewed, the maximum over- or underweight is 5 per cent, with more usually 2 per cent, except for larger index constituents such as Brazil, which could be 5 – 10 per cent.³⁴ A good example of an exceptional circumstance is the Argentine default, the widespread expectation of which resulted in funds holding far below Argentina’s index level.³⁵ Even in this extreme example (the largest-ever default [Datz 2007: 18]), however, the requirement to limit deviation from the index meant that some fund managers still retained holdings despite their expectations (see note 35 below; Blustein 2005: 70; Santiso 2003: 75). A similar situation may have occurred in Brazil before the 2002 elections (Hardie 2006). For the small number of countries that constitute a large proportion of the index, therefore, there is a possibility of loyalty caused by an inability

³² These figures take no account of domestic ownership of legally international debt.

³³ Fund manager, London, interviewed 15 February 2006.

³⁴ Economist, fund management company, New York, interviewed 31 May 2006.

³⁵ ‘[W]hen Argentina was going under, I think pretty much every manager we had in [an] EMBI plus fund was massively underweight, or in certain instances zero in Argentina, and Argentina of course was the largest component in the index to start the year’ (fund manager, London, interviewed 21 October 2005); also fund manager, London, interviewed 16 February 2006.

to exit fully. Index investors may be as underweight as they can be, but still have an investment.³⁶ This creates an unusual interest for the fund manager. Optimal performance relative to the index for the whole portfolio will result from the worst performance (including default) of individual bonds which s/he owns. For example, a fund could have had its minimum possible holding of Argentinean bonds, say 5 per cent of the funds' investments, when Argentina defaulted. The fund would lose money as a result of the default, but the performance of the fund relative to the index – the fund managers' main concern – would be enhanced by that default. In practice, this observation covers only a very small number of countries – Brazil, Mexico and Russia (and Argentina prior to default). As already discussed above, in a fund that looks only at beta, rather than an absolute prohibition on deviation from the index weighting, Mexico (and possibly now Russia's) low yields mean the limitation may not apply. Nevertheless, in the specific case of Brazil, we have a loyalty engendered by the nature of performance measurement, rather than loyalty enforced by Brazilian government regulation.³⁷

The nature of index investment has an influence on the level of international investor interest in a country, and therefore on its internationalisation and financialisation. For smaller index constituents, there are disincentives to pay the transaction costs to be involved unless the potential return is high, because limits on investment relative to the index mean that the costs are not rewarded through enhanced portfolio performance. A country is a small constituent of the index only in part because of government policies. For the larger constituents, however, index investors can exhibit loyalty that is the result of an inability to exit fully.

³⁶ '[T]he fact that it[Brazil]'s a big part of the index mean that a lot of people need to own it, in big amounts' (hedge fund manager, London, interviewed 23 June 2005); also investment bank strategist, London, interviewed 5 January 2005; investment bank strategist, London, interviewed 23 June 2005.

³⁷ EU regulation, Undertakings for Collective Investments in Transferable Securities ('UCITS') (see http://ec.europa.eu/internal_market/securities/ucits/index_en.htm, accessed 22 May 2007), serves to undermine this loyalty by limiting the exposure of a fund marketed to retail investors across the EU to 10 per cent in a single, non-OECD or EU credit. This was one of the incentives behind the JP Morgan EMBI Global Diversified, which limits each country's weighting in the index. A 10 per cent 'underweight' would mean no investment in all countries except Mexico and Russia, whose weightings are only very slightly over 10 per cent (JP Morgan 2004: 7). Turkey, as an OECD country, may be a beneficiary of this (fund manager, London, interviewed 15 February 2006).

Absolute Return Investors

The extent to which particular investment funds can be seen as index benchmarks varies, and a distinction between index benchmarks and total return investors such as hedge funds is in some ways too stark (see chapter 4 on the difficulties of distinguishing hedge funds from other investors). Even for those targeting absolute return, the performance of one of the market indices can remain important. There is often an element of investors wanting to have their cake and eat it too, looking at the index return when it is strong, but focusing on total return in a weak market.³⁸ The index is also the measure for the overall market, and will therefore influence decision making.³⁹ Nevertheless, the contrast is important, and is recognised by interviewees, including fund managers who managed both types of fund.⁴⁰ For absolute return investors, different factors tend to be more dominant in determining where to invest. In particular, these funds tend to be themselves more financialised: they have investment mandates that allow a greater range of financial instruments to be traded, and are allowed to short. Therefore, where they are able to fulfil those strategies, where the market itself is more financialised, becomes an important consideration regarding where to invest. Most importantly, the ability to short means that these investors will be interested in becoming involved in a market regardless of whether they view the policies positively or negatively. Unlike investors that follow an index, their ability to express disloyalty means that absolute return investors can profit by being involved in a market where prices fall or rise. Internationalisation therefore is determined not by the pull factor of a

³⁸ '[T]hat index will always be there whether or not...it's an index return or an absolute return [fund]. So a lot of investors...insurance companies particularly, will say...we have a target return of 7, 8, 9, 10 per cent, and we want you to beat that and...you're investing in this asset class, so here's an index and...if you beat the index and you match our return target that's fine. But if the index is down 5 per cent...you have to be flat' (fund manager, London, interviewed 15 February 2006); 'we're being measured in three ways. One is absolute performance. Two is versus other hedge funds, and three, versus the EMBI' (hedge fund manager, London, interviewed 18 February 2005).

³⁹ '[T]he first thing we do is we try to figure out if...emerging markets debt is likely to go up or down, and when we say up or down...we look at the index' (hedge fund manager, London, interviewed 18 February 2005).

⁴⁰ Fund manager, London, interviewed 21 October 2005; fund manager, London, interviewed 16 February 2006.

country's macroeconomic policy, but by the level of financialisation in the government bond market.

Like all investors, absolute return investors focus on risk management. This will be important in a number of ways. Most obviously, there will tend to be a maximum exposure to a single credit. Either explicitly or implicitly, this maximum exposure is influenced by liquidity. In one hedge fund, individual borrowers are judged on credit quality and liquidity, with a maximum exposure of 25 per cent of the fund for those ranked as low quality;⁴¹ another simply has a 25 per cent maximum in any one country,⁴² another 20 per cent.⁴³ A (large) fund management company sets a maximum of 25 per cent of the fund in one country, but liquidity concerns mean this is generally only reached, regardless of the view on the credit, in Argentina, Brazil and Russia.⁴⁴ Another, slightly differently, looks at beta (see above), with a 15 per cent maximum for a low beta asset, and 8 – 10 per cent for a high beta asset such as Brazil.⁴⁵ In contrast to those funds that are measured relative to an index (other than those using the EMBI diversified because of EU regulation; see note 37 above), these limits would tend to be slightly more constraining than the limits on being overweight relative to the index. A 10 per cent overweight in Brazil, the largest index constituent, would mean 29 per cent of a portfolio being invested there. However, the contrast in this regard between the two types of funds is not marked. It is potentially more significant for the smaller index constituents, where the limitation on overweight might be considerably more restrictive for an index-benchmarked fund. One absolute return fund was reported to have had a third of its portfolio in Ecuador, for example.⁴⁶

It is in the event of a negative view that the contrast with index funds in regard to the large index constituents is more marked: there is no requirement to be invested in a

⁴¹ Hedge fund manager, London, interviewed 23 June 2005.

⁴² Hedge fund manager, New York, interviewed 15 May 2006.

⁴³ Hedge fund manager, New York, interviewed 18 May 2006.

⁴⁴ Fund manager, London, interviewed 3 February 2006.

⁴⁵ Fund manager, London, interviewed 21 October 2005.

⁴⁶ Fund manager, London, interviewed 16 February 2006.

credit, as with some index funds, and so no possibility of loyalty from this influence. Such funds can ‘cherry pick’⁴⁷ from among the available possibilities, investing only in the ‘best ideas’.⁴⁸ In a key link between financialisation and loyalty, the more freedom a fund has under its investment mandate, and therefore the more options of where to invest, the less loyalty there will be to any individual type of investment. This greater freedom can also allow a fund to exit emerging market assets completely, by holding ‘cash’ (likely to include G7 government bonds). An absolute return investor, especially a hedge fund, is more likely to be able to simply exit the market and hold cash if there appears to temporarily be no attractive opportunities.⁴⁹ One hedge fund interviewed had been 100 per cent ‘in cash’ at one stage,⁵⁰ and another had no limit on the percentage of the fund that could be in cash.⁵¹ Furthermore, as previously discussed, for many absolute return investors, there is the ability not only to exit fully, but to express disloyalty.

The further characteristic of absolute return investors is that they are more likely to employ leverage, to borrow to increase the size of their investments. This use of leverage is linked to a generally more short term, trading-oriented investment strategy. In particular, leverage can make them ‘highly vulnerable in bear markets’ (Davis and Steil 2001: 18) if they have long positions. The frequent reporting of performance for hedge funds (see chapter 4), and the need to meet increased margin calls in the event of price falls (see MacKenzie 2003 for the role of margin calls in the collapse of the hedge fund Long Term Capital Management) also act to make hedge funds more short term. Chadha and Jansen (1998: 34) add two further constraints on risk taking. The fee structure of hedge funds is biased towards rewarding performance rather than the volume of funds under management. This means that hedge fund managers, in contrast

⁴⁷ Hedge fund manager, New York, interviewed 18 May 2006.

⁴⁸ ‘[T]hey just come up with their best ideas and if something is 2 per cent in the index, you either own it or you don’t own it. By owning it, you own 5 per cent, if you don’t own it, you own zero and you don’t worry about what its weighting is in the index’ (fund manager, London, interviewed 21 October 2005).

⁴⁹ Obviously, this can only be a short term option. Hedge funds specialising in convertible bond arbitrage, for example, have been wound up when opportunities in that market disappeared for an extended period, in a situation similar to that discussed by Grossman and Stiglitz (1980).

⁵⁰ Hedge fund manager, London, interviewed 23 June 2005.

⁵¹ Hedge fund manager, New York, interviewed 15 May 2006.

to other institutional investors, earn little in the event of a negative return. Also, hedge fund managers are generally expected to invest substantial amounts of their own money in the funds they manage, reducing the tolerance for loss.

As a result of all these factors, hedge funds generally have tight ‘stop-loss’ constraints (see chapter 4). Once investors with stop losses become involved in a market, they are likely to make it more volatile.⁵² A stop-loss is a limit on how far a single investment (or less commonly a whole portfolio) can be showing a loss on a mark-to-market basis before it must be sold, regardless of any view on the market. As a result, even if the trader is confident of the medium term outlook for the investment, s/he must be concerned with any short term price weakness (Hardie and MacKenzie 2007a; Beunza *et al.* 2006. For limits on arbitrage more generally, see Shleifer and Vishny 1997). As a result, one hedge fund interviewed would only invest in positions which could be sold at any time of day.⁵³ This can be a significant constraint: one trader considered only Brazil and Russia trade with equal liquidity outside their own time zones.⁵⁴

Two factors are therefore important in determining the involvement of absolute return investors in a financial market. The first is liquidity (Davis and Steil 2001: 13; Bekaert and Harvey 2003; de la Torres and Schmuckler 2005; Borensztein *et al.* 2006⁵⁵), necessary to reverse an investment, the second is what financial instruments are available, which is important in determining what investments can be made and with what transaction costs. An illiquid market can make entry difficult for larger funds, as they risk moving market prices higher as they try to buy the bonds they want.⁵⁶ However, any investor must also consider if exit will be required before the maturity of

⁵² ‘I think [if] it weren’t for stop losses a lot of markets would be less volatile’ (hedge fund manager, New York, interviewed 15 May 2006).

⁵³ Hedge fund manager, New York, interviewed 18 May 2006.

⁵⁴ Head of Emerging Market Bond Trading, investment bank, New York, interviewed 17 May 2006.

⁵⁵ Liquidity is more commonly seen as discouraging international investors generally, not more specifically absolute return investors.

⁵⁶ Economist, fund management company, New York, interviewed 31 May 2006.

the bond, and, if so, the strategy for exit. For a fund with stop loss constraints, exit can be necessary at any time if prices move in the wrong direction. Liquidity is important:

[B]ecause it gives you the opportunity to change your mind, if you're right or if you're wrong. The lack of liquidity is terrible, even if you're right...you can't change your mind, it's working fine, suddenly it doesn't work anymore and there is nothing you can do about it... We tend to trade more on let's say the Brazil, the Turkeys, the Russias, ... Mexico, Argentina...I concentrate... where there is more liquidity.⁵⁷

This contrasts with an illiquid market, where a stop loss 'just makes no sense. If positions [are] going against me, most likely I will not find a bid for my bonds anyway'.⁵⁸ For the investor discussed above as needing 24 hour liquidity, this is generally achieved by using options (including for a one-off investment in Lebanese US dollar bond options).⁵⁹ Reversing a position does not only have to be by way of outright purchase or sale; hedging, totally or partially, is also considered. The easier it is to hedge (another result of increased financialisation), the more attractive a market will be to international investors. An interviewee contrasted, for example, Mexico's longer maturity swap market, which makes hedging (and therefore exit) easier, with Brazil, where the swap market is only available at shorter maturities.⁶⁰ In the international market, hedging can be done using the credit derivatives market (see chapter 2), although at present this can be difficult in a very weak market.⁶¹ The question of hedging becomes more interesting when international investors enter a domestic market. In buying longer dated securities, international investors often buy securities which will be difficult to exit in the event of a weak market. Their response can be to hedge their risk by selling other assets from the same country. These could be shorter maturity

⁵⁷ Hedge fund manager, Brazil, interviewed 11 September 2006.

⁵⁸ Emerging market bond trader, London, interviewed 18 October 2005.

⁵⁹ Hedge fund manager, New York, interviewed 18 May 2006.

⁶⁰ Strategist, hedge fund, New York, interviewed 15 May 2006.

⁶¹ '[I]f the shit's hitting the fan, then CDS tends to be...very much a one-way street because it's traded by hedge funds mainly, where you don't have any capacity to take VAR [value at risk]...they have to cut positions and so...it's a much more dislocated market than say the FX [foreign exchange] market, where there's real flows' (fund manager, London, interviewed 16 February 2006).

securities,⁶² or, because the largest part of the risk involved in investing in a domestic market is the foreign exchange risk, hedging can take place in the foreign exchange market.⁶³ This has a number of implications, including for the appropriate level of foreign exchange reserves for an emerging market central bank, which are not central to this thesis. Nevertheless, this is a further example of how increased financialisation, the ability to hedge, will increase internationalisation.

In Lebanon, the activities of the domestic commercial banks make it difficult to short the market, both because of the inability to borrow bonds, and because the local investor activity limits the extent of any price weakness (see chapter 2). This serves to further discourage involvement by total return investors, because they cannot express a negative view on the country's bonds.⁶⁴ Increased financialisation is therefore likely to increase the involvement of those investors who need this increased liquidity (although even longer-term investors must consider liquidity⁶⁵). Government policy regarding borrowing can serve to increase financialisation in a variety of ways. Creating larger, and therefore more liquid, individual bond issues is one example,⁶⁶ the use of domestic market 'primary dealers', banks with an obligation to make markets (as in both Brazil and Turkey), and making domestic currency bonds available to international investors through the government issuing Eurobonds denominated in the domestic currency (as in Brazil), or allowing domestic securities to be settled through Euroclear (as Mexico has done) are others. All serve to increase financialisation. These government policy

⁶² Strategist, hedge fund, New York, interviewed 15 May 2006.

⁶³ Fund manager, London, interviewed 15 February 2006; fund manager, London, interviewed 16 February 2006.

⁶⁴ '[M]any guys used to try to short the country, internationally, if they could find the bonds to short, and ...no one ever really made money doing that. So...it became a country which people really ignored...because it wasn't a country people could make money on from shorting, because of the underlying domestic bid but at the same time people weren't comfortable because they thought it was trading rich through its fundamentals' (fund manager, London, interviewed 21 October 2005).

⁶⁵ For example, fund manager, insurance company, London, interviewed 14 February 2006; economist, fund management company, New York, interviewed 31 May 2006.

⁶⁶ Though this strategy can be criticised: 'in my opinion it's really bad for the issuers to have these big liquid trading bonds because when speculators smell something is going wrong they go out and sell the hell out of it, and they [the borrowers] can't finance' (emerging market bond trader, New York, interviewed 18 May 2006).

initiatives are all relatively technical and have been rarely considered in studies of financial globalisation. Other small-scale changes, such as financial innovation and changes in particular investors' investment mandates, also serve to increase financialisation, but are outside government policy.

Prior to Brazil's policy of repurchasing foreign currency debt, Brazil was the extreme example of high liquidity in international emerging market bonds. In part as a result of the issuance of Brady bonds during the resolution of the 1980s debt crisis, Brazil had the largest individual issues outstanding, and was therefore the most easily traded. The result is that it was possible to sell \$500 million Brazilian bonds 'in a couple of hours'.⁶⁷ One investment bank interviewed traded more Brazilian bonds than bonds issued by the bank itself, and the most liquid Brazilian issue traded with a 'bid-offer' (i.e., the difference in the price at which it can be bought and sold) of 0.10 per cent, a fifth of that of investment grade U.S. corporate debt.⁶⁸ In addition, traders pay half the amount to inter-dealer brokers to trade Brazilian government bonds as Turkish.⁶⁹ The result is that 'the unique thing about Brazil is that Brazil is the bellwether for the whole asset class...if somebody wants to buy the asset class...the first thing they think about is buying Brazil, or they want to sell the asset class, they think of selling Brazil'.⁷⁰ The bid-offer spread on Turkish domestic bonds is also wider than that on Brazilian (Borensztein *et al.* 2007: 149). Ease of exit, meaning there is no requirement for loyalty, can be seen as serving also to encourage entry, and therefore be a positive (de la Torres and Schmuckler 2005). However, in the case of Brazil, there was an asymmetry. The 'asset class benchmark' is the Brazilian bond maturing in 2040,⁷¹ and this bond is, as a result, 'everybody's favourite short. So if you don't like EM [emerging markets debt], if you're a macro hedge fund that doesn't even know EM but...has just heard that EM is shitty,

⁶⁷ Strategist, fund management company, London, interviewed 14 February 2006.

⁶⁸ Head of Emerging Market Bond Trading, investment bank, New York, interviewed 17 May 2006; emerging market bond trader, New York, interviewed 18 May 2006.

⁶⁹ Head of Emerging Market Bond Trading, investment bank, New York, interviewed 17 May 2006.

⁷⁰ Hedge fund manager, London, interviewed 23 June 2005; emerging market bond trader, London, interviewed 17 February 2005; hedge fund manager, London, interviewed 18 February 2005.

⁷¹ Strategist, hedge fund, London, interviewed 18 February 2005.

you'll short Brazil...Brazil [20]40 is there for you to short, everyday'.⁷² In addition, Brazil's US dollar bonds are sold 'to hedge everything'.⁷³ When the market is strong, however, a wider range of bonds are liquid and can be purchased. Beunza *et al.* (2006: 726) discuss a short-term trade which exploits just this difference. In a weak market, the more liquid Brazil 2040 bond fell more in price than other Brazilian bonds. A hedge fund manager was therefore able to buy the Brazil 2040 bond, and simultaneously sell another less liquid Brazilian bond maturing in 2014. When the market stabilised, the Brazil 2040 outperformed Brazil 2014, realising a profit for the hedge fund. In this case the trade is short-term in nature, and quickly reversed.

The fact that being the asset class benchmark 'makes Brazil more volatile',⁷⁴ may not be seen as of long term importance, but Keynes' view, if in a different context, is appropriate here: '[T]his *long run* is a misleading guide to current affairs. In *the long run* we are all dead. Economists set themselves too easy, too useless a task if in tempestuous seasons they can only tell us that when the storm is long past the ocean is flat again' (quoted by Frieden 2006: 153; italics in original; see also Maxfield 1990). In an exceptionally weak market, the ability to continue trading is likely to result in greater price falls for that instrument. A comparison of Brazil in 2002 with Turkey in 2001 or Lebanon in 2005 supports such a view. The falls in Brazil (triggered by political uncertainty ahead of Lula's election) came to be seen as a 'death spiral' (Krugman 2002: 2). Illiquidity therefore becomes something similar to a 'circuit breaker' that suspends trading on stock market or futures exchange in the event of substantial price falls (Borensztein *et al.* 2007: 149⁷⁵). In addition, the different levels of liquidity also influence decisions to buy and the time scale of any investment, because of the factors which might influence price movements:

⁷² Strategist, investment bank, London, interviewed 23 June 2006; also Head of Emerging Market Bond Trading, investment bank, New York, interviewed 17 May 2006.

⁷³ Head of Emerging Market Bond Trading, investment bank, New York, interviewed 17 May 2006.

⁷⁴ Strategist, hedge fund, London, interviewed 18 February 2005; also Head of Emerging Market Bond Trading, investment bank, New York, interviewed 17 May 2006.

⁷⁵ Borensztein *et al.* conclude, in support of the primacy of market efficiency, 'these mechanisms...may slow the convergence of an asset to its fundamental value' (2007: 149).

[I]f you think for example Gazprom [a Russian energy company] is cheap, it is easier to buy a lot of Gazprom and hold on to that view, hold on to that issue, whereas if you think Brazil is cheap, and you buy the Brazil 40s it's more difficult to hold on to it because there might be something other than its fundamentals which has...negative force, and therefore...you might end up selling it for different reasons.⁷⁶

The greater liquidity of the Brazilian issue makes it easier to short, to express disloyalty, and means that a greater range of international investors are active in buying and selling. The larger issue size, increased financialisation, serves to increase internationalisation. Not only does it serve to increase international involvement, but increases the extent to which prices are influenced by more global, 'push' factors rather than Brazil's domestic, 'pull' factors.

For absolute return investors, two connected factors, both aspects of financialisation, are dominant in their considerations of whether to be involved in a particular government bond market. The first is liquidity, which is primarily important as in providing the ability to reverse a position – not 'exit' a position, as the position reversed could be a short – which is important because of the short term nature of the positions taken and the use of leverage. The presence of liquidity is in part the result of government policy choice, but the size of the economy is, once again, likely to be an influence. The second determinant is a level of financialisation of the government bond market sufficient to allow a wide range of investment strategies, particularly the ability to short. As previously discussed, this is another area that is only in part the result of government policy choices.

The Changing Nature of Investment Mandates

This section focuses on the increased flexibility within the investment mandates of institutional investors in emerging market debt. These changes serve to increase

⁷⁶ Hedge fund manager, London, interviewed 23 June 2005.

financialisation and move an overall government bond market further to the right on a graph of the autonomy curve. Institutional investors can only do what their investment mandates allow them, and this can vary with each fund managed.⁷⁷ Within the group of international investors, increased financialisation can come from three distinct processes. First, the development of new types of investor, most obviously in recent years the emergence of hedge funds, with consequences already discussed. Second, existing fund management companies starting funds with different investment mandates. As mentioned above, two fund managers interviewed had recently started hedge funds, for example.⁷⁸ Funds able to invest in local currency bonds are another development.⁷⁹ A third, less obvious, change is potentially the most significant. This is changes in the investment mandates of funds themselves, allowing the fund manager greater freedom to choose the financial instruments in which to invest.⁸⁰

All three of these developments increase financialisation, but it is the third that will be the focus here. This change works on two different levels, both at the level of the emerging market bond funds themselves, and of the institutional investors who invest with them. At the level of the funds themselves, the process is clearly towards greater financialisation. As new financial instruments, such as credit default swaps, or new markets, such as domestic bond markets, become available, fund managers make arguments that their funds should be able to invest in these, and, as investor demand and regulatory constraints allow, these changes are made,⁸¹ such that ‘even those guys that

⁷⁷ ‘[D]ifferent funds of course have more flexibility than others. Some like our US mutual fund product, that’s going to be pretty much long vanilla only, and...even though...we’ll have some with local currency in it, it’s not going to have any bells and whistles on it. We... trade CDS as well, but that’s not going to feature in a US open ended mutual fund’ (fund manager, London, interviewed 21 October 2005).

⁷⁸ Fund manager, London, interviewed 21 October 2005; fund manager, London, interviewed 16 February 2006.

⁷⁹ Economist, fund management company, New York, interviewed 31 May 2006.

⁸⁰ For discussion of the increased financialisation of US and UK pension funds, see Langley 2004.

⁸¹ ‘[H]istorically we just like so many other guys were pretty much EMBI benchmark investors, but that of course has evolved over time, to include both more local currency investments and also just more total return product. So both long and short, and total return product involving both local and hard currency as well’ (fund manager, London, interviewed 21 October 2005); ‘a lot of the big real money guys have started up within their funds...local funds so a lot of them can take local exposure’ (emerging market bond trader, New York, interviewed 18 May 2006).

can't [trade credit default swaps] are slowly getting their act together'.⁸² This can apply equally to hedge funds. Although they would generally start with the ability to invest across a wide range of sophisticated financial instruments, they may move from bonds into other areas such as equities,⁸³ with consequences similar to those already discussed regarding domestic investors.

A significant further change is at the level of the institutional investors who invest in emerging market funds, principally developed world pension funds. Pension funds have in recent years been moving steadily into emerging markets.⁸⁴ The activities of these investors fit very well with Maxfield's (1998b) view of them as patient capital,⁸⁵ and they are clearly less of a constraint on government policy autonomy than shorter-term investors. Longer term investors are less likely to wish to exit in the event of short-term negative events. An example can be seen in the case of Turkey:

There is a tax issue [that] just came out,⁸⁶ and most of the hedge funds...started selling, they just all are offloading. But the real money accounts, they just stayed because the real money accounts, pension funds actually...they just buy and hold, they don't care about days... okay they will not wait until the crash, but the fluctuations doesn't matter for them.⁸⁷

⁸² Emerging market bond trader, New York, interviewed 18 May 2006.

⁸³ '[E]ven a dedicated hedge fund, dedicated to EM, they're going to do currencies, very likely at some point they're going to do commodities and then at some point they're going to do equities as well' (emerging market bond trader, New York, interviewed 18 May 2006).

⁸⁴ '[T]he big thing that's happened really starting in 2002, was the advent of the pension group...it started...in places like the Netherlands but the really big bulk of the money and the one that's...seen the way forward has been the US public pension fund market...And our clients are predominantly long term institutional investors. The largest component being pension funds, you have central bank money, insurance companies...It's long term money, it's the people who've said okay I want to do this in the next 10, 20 years' (Head of Research, fund management company, London, interviewed 14 February 2006).

⁸⁵ Although Maxfield sees these investors as motivated primarily by pull factors, whereas it appears to be pension fund deficits that are also important in prompting a search for higher return alternatives (Head of Research, fund management company, interviewed 14 February 2006).

⁸⁶ The interviewee is referring to uncertainty surrounding the new tax treatment of domestic securities.

⁸⁷ Economist, foreign bank, Turkey, interviewed 5 December 2005.

Interviewees also observed that some of the biggest hedge funds had largely withdrawn from emerging market bonds, preferring the foreign exchange market as more liquid,⁸⁸ demonstrating that the ability to trade risk relative to the size of a particular fund is also important. Although a large fund size reduces transaction costs such as information gathering, it also makes it necessary to trade in larger size to have an impact on overall portfolio return, reducing the markets in which this can be done.

The Role of Investment Banks in Internationalisation

International investment banks occupy a central position as intermediaries in global financial markets. 'Fixed costs generate economies of scale, and, hence, the financial industry is likely to organize itself around *clusters of specialists*' (Calvo 1999: 3; italics in original). In the emerging debt market, the most important cluster is the international investment banks, whose activities serve to reduce transaction costs,⁸⁹ thereby facilitating the entry of international investors into a market and increasing internationalisation. The choices the investment banks make are therefore central to the speed of financialisation in individual countries.

Investment banks are important in reducing information costs, through the activities of research analysts. The role of analysts, and in particular their independence, remain highly controversial, especially since the collapse of the 'technology boom' after 2001. The larger investors will carry out their own research 'in-house', and rely little on external analysts. Investors interviewed also claim to make up their own minds regarding their investments, rather than following analysts' recommendations. For many investors, however, investment bank research analysts remain an important source of

⁸⁸ Head of Emerging Market Bond Trading, investment bank, New York, interviewed 17 May 2006; Head of Research, fund management company, interviewed 14 February 2006.

⁸⁹ Fund management companies specialising in emerging markets, in which other less specialised investors can invest, similarly reduce transaction costs (Head of Research, fund management company, London, interviewed 14 February 2006).

information, saving the cost of independent information gathering.⁹⁰ The quality of this information gathering will vary considerably. This is in part, of course, because of the quality of the individual analysts, but it is also because of their choice (or, more accurately, their managers' choice) of where to spend their time. An individual analyst, possessed of a set of analytical skills, can apply those skills to the analysis of one country or ten. Investors notice the difference:

I get a lot of information from several institutions who I can call someone up and say, what do you think of Turkey...but what do you think of Lebanon? Wait a minute I'll get the guy who takes care of Ecuador, Ivory Coast, blah blah blah and Lebanon to talk to you. So the guy hasn't got an in-depth, necessarily, knowledge, as the guy of Turkey. They have one economist for Turkey, one economist for Brazil, one for Russia, for the big ones so you really know what's going on.⁹¹

Where investment banks choose to dedicate their resources serves to increase the speed of internationalisation, by making it easier for investors to have the information they feel is necessary for successful investment. The involvement of international investment banks increases the number of investors likely to become involved in a particular country. Investment banks are by no means the only sources of information, nor are their views on creditworthiness necessarily the most influential – the rating agencies⁹² (Sinclair 2005) and the International Monetary Fund were both mentioned frequently by interviewees. However, investment banks are important sources of information, and are likely to be the most proactive in sharing that information, in order to generate increased business. There is a possibility of an autocatalytic process, whereby increased research leads to increased investment flows, leading to increased research, but events outside the

⁹⁰ 'I use things provided by the Wall Street community, not so much for views but just information flow, maintenance mostly....[F]undamental research I do on my own....Rather than going through all these Reuters pages or Bloomberg pages, to hunt down every economic number that comes out in every country, ...in the morning, brokers summarise the day's events... I happily read that and save myself an hour's work' (strategist, hedge fund, London, interviewed 18 February 2005).

⁹¹ Hedge fund manager, Brazil, interviewed 11 September 2006.

⁹² Though the view on the agencies ranged from 'I very, very highly value rating agencies' (analyst, investment bank, interviewed 5 January 2005) to a view that their 'misrepresentation' creates investment opportunities (economist, fund management company, New York, interviewed 31 May 2006).

market can also have a strong influence, such as Turkey's EU accession process increasing the range of investors able to consider investment (Hardie and Mosley 2007).

There is clearly a group of analysts who specialise in a single country, almost regardless of its size: domestic research analysts, who are active in all three case study countries. It is clear from interviewees, however, that they enjoy a lower level of influence than their international counterparts. For some international investors, this is based on the view that the international research is 'better quality'.⁹³ However, this seems an inadequate explanation, particularly given the experience of one Turkish analyst, who, moving from a Turkish to an international bank, found his views immediately received far more attention.⁹⁴ Part of the reason is likely to be the efficiency of contacting a smaller number of banks. In addition, investors tend to limit their counterparties, for a variety of reasons of which efficiency is only one (see below). Those banks that are not counterparties will not receive business in return for their research.⁹⁵ International analysts are favoured despite there being almost a consensus amongst international interviewees that locals had a more in-depth knowledge of the country, especially the politics.⁹⁶ The line between local and international also blurs from two developments. First, international investment banks hire local nationals to trade or research their own countries. As with the decision on where to concentrate research resources, this tends to favour the larger countries. The dominance of Turkish analysts in researching Turkey appears particularly marked.⁹⁷ Of the four research analysts covering Turkey interviewed in London as part of this research, three are Turks. The second development is even more significant: international banks set up operations in the larger markets, and supply locally-based research capabilities, combining the credibility of the international

⁹³ Strategist, hedge fund, interviewed 18 February 2005.

⁹⁴ Economist, foreign bank, Turkey, interviewed 5 December 2005.

⁹⁵ '[T]hese guys can't build a secondary market relationship with us anyway, because they don't have the credit lines' (fund manager, London, interviewed 16 February 2006).

⁹⁶ For example, emerging market bond trader, London, interviewed 18 February 2005; strategist, investment bank, London, interviewed 5 January 2005; research analyst, investment bank, London, interviewed 17 February 2005; strategist, hedge fund, London, interviewed 18 February 2005.

⁹⁷ This may also be influenced by the importance of language skills alone, rather than a more general experience of the country. Foreign analysts are more likely to speak Arabic, Portuguese, Russian, and particularly Spanish.

firm with the advantages of locally-based expertise.⁹⁸ This internationalisation serves to reduce the costs for international investors in gathering information they trust.

International investment banks also reduce transaction costs significantly in the area of actually making investments, buying and selling financial instruments. This is especially the case where the various derivative structures can avoid difficulties, including the fact that many funds have to settle their trades (i.e., exchange cash for ownership of the securities) through Euroclear, the main international settlement company in Europe.⁹⁹ There are incentives for the larger funds to meet the requirements for direct investment in a country (particularly a destination for larger volumes of investment), including potential concerns with some of the documentary requirements of the investment banks' derivative structures,¹⁰⁰ but this is not worthwhile for smaller funds. Furthermore, the investment banks make a higher profit margin on these structured trades than on trading 'vanilla' bonds, and so have an incentive to concentrate on finding these tailored solutions to their investment clients' requirements,¹⁰¹ increasing innovation and financialisation.

For some funds, the requirements of their investors as to acceptable counterparties (i.e., those banks with which they trade) mean they cannot deal with domestic market makers at all,¹⁰² so if international banks are not involved in a market, nor can they be.

Alternatively, even where local intermediaries are acceptable as counterparties, it will

⁹⁸ '[W]hen you talk to the São Paulo office of JP Morgan, is he a local? Is he an international? I guess he's a combination thereof, but you get that local flavour' (fund manager, London, interviewed 21 October 2005); also hedge fund manager, London, interviewed 23 June 2005.

⁹⁹ Fund manager, London, interviewed 21 October 2005; fund manager, London, interviewed 16 February 2006.

¹⁰⁰ Head of Research, fund management company, London, interviewed 14 February 2006; fund manager, London, interviewed 21 October 2005; fund manager, London, interviewed 16 February 2006.

¹⁰¹ Emerging market bond trader, New York, interviewed 18 May 2006; emerging market bond trader, London, interviewed 18 October 2005.

¹⁰² A pension fund, for example, might have a minimum A rating for a counterparty (fund manager, London, interviewed 3 February 2006); 'we don't deal with any local counterparties, it's as simple as that. We deal with major banks' (Head of Research, fund management company, London, interviewed 14 February 2006); also fund manager, London, interviewed 16 February 2006.

only be for smaller-sized trades.¹⁰³ The issue of custodians is another example. Custodians are the institutions who hold assets on behalf of the fund management company. It is easier to have a large international bank act as custodian across a range of markets rather than go through the process of appointing local custodians in each market.¹⁰⁴ A local custodian may also not be acceptable to the investor in the fund.¹⁰⁵ These constraints are all significant, but even when they are not a factor, the question of efficiency is important. Fund managers are limited in the number of different banks they can spend time talking to and dealing with. This inevitably pushes them towards those banks that can offer a wider range of services, and so to the larger, international investment banks. Otherwise ‘I end up having a hundred different counterparties. It’s not efficient’.¹⁰⁶ Especially for the smaller funds, there is also a desire to establish a relationship, so that if there is a difficult market, the counterparty will be more inclined to bid for bonds to preserve the relationship.¹⁰⁷ A relationship is established by a flow of business, which favours concentrating business with a small number of counterparties. As a result, internationalisation, as in an international investment bank becoming involved in trading a market, is likely to lead to further internationalisation, as an increased number of investors not only receive information about a market, but also finding it easier to transact in that market.

For international investors, transaction costs are lower in markets such as Brazil and Turkey, where investment banks have a very high involvement, with offices in São Paulo and Istanbul trading and researching the local market. Transaction costs are higher in Lebanon, where international banks hardly trade the domestic market, and research is undertaken by an analyst who focuses simultaneously on a number of different countries. Investment banks will choose to become involved in a market if they can

¹⁰³ Hedge fund manager, London, interviewed 15 February 2006.

¹⁰⁴ Fund manager, London, interviewed 3 February 2006; fund manager, London, interviewed 21 October 2005.

¹⁰⁵ Fund manager, London, interviewed 16 February 2006.

¹⁰⁶ Hedge fund manager, London, interviewed 23 June 2005.

¹⁰⁷ Otherwise ‘when I need them to bid, they don’t have to give me a bid, and I don’t have a relationship with them’ (hedge fund manager, London, interviewed 23 June 2005).

make a profit from their own proprietary trading activities and from dealing with their investment clients. The combination of having clients and the investment banks' economies of scale mean the influences on the decision to be involved are not the same as for an institutional investor, and investment banks are likely to become involved earlier. Most importantly, the impediments to entry into a market, exactly those deterrents to international investor involvement, create a business opportunity for the investment banks,¹⁰⁸ provided the level of financialisation is sufficient.¹⁰⁹ Investment banks are therefore at the forefront of (legally) circumventing restrictions on entry, and will serve to encourage internationalisation and financialisation through their activities.

The Impact of Internationalisation on a Government Bond Market

Internationalisation increases financialisation, but is also increased by financialisation, by making a market more attractive to international market actors, particularly more short-term investors. In addition, internationalisation serves to decrease a government's autonomy from the policy preferences of international investors, even if different investor types constrain autonomy to varying degrees. Why then would governments actively encourage this internationalisation? One possible answer is obvious: governments seek to borrow from the broadest possible group of investors. Increased demand with a constant supply (government borrowing) will reduce cost (interest rates on the debt). A further argument used is that a broad range of investors with differing views and investment requirements should contribute to a more stable market.¹¹⁰ These arguments will be explored further in the concluding chapter.

¹⁰⁸ 'It's the costs of the entry barriers, the costs they [investors] have to put in to get into this market are not worth it. But for me who can make it a business servicing a lot of different clients...the economics of that are already very different. For me it's worth it' (emerging market bond trader, London, interviewed 18 October 2005).

¹⁰⁹ 'I can always sell to a foreigner in any synthetic format I like. I can do a ceiling, I can do a total return swap, I can do whatever. But I'll find a pocket internationally somewhere in the world in some format I might be able to sell this type of risk' (emerging market bond trader, London, interviewed 18 October 2005).

¹¹⁰ A justification used by, for example, senior official, Banco Central do Brasil, interviewed 5 September 2006. See also Crockett 2007.

A less discussed advantage of international investors has been seen in both Brazil and Turkey: these investors' willingness to buy longer maturity bonds in the domestic market (even if their actual investment horizons are shorter than the maturity of the bonds) has been used by the authorities in both countries to issue longer term bonds. These have been mainly fixed rate in the case of Turkey, inflation-linked in Brazil. In Turkey, the initial impetus was the development of the Eurolira market, Turkish lira denominated bonds issued by non-Turkish entities and swapped onto another currency. The hedging of these swaps created loyal demand for longer-dated Turkish government bonds (Hardie and Mosley 2007).¹¹¹ A Turkish Treasury official¹¹² estimated that 80 – 85 per cent of the first auction of 5 year government bonds was sold to international banks hedging swap positions. The successful issuance and subsequent price performance of these longer maturity securities then encourages domestic interest:

[I]n the first stage, the local banks were saying I will never buy...that security, it's impossible for us,...because...our customers, especially deposit customers, they are not extending their maturities, the average maturity is six months one year and blah blah blah so we cannot buy those securities and so on... nowadays, they saw that there is...a nice profit with those securities and they are calling us and they are asking us when are you going to reissue those securities. So I think...the local ones also will get used to those maturities, coupons, securities and so on.¹¹³

A similar strategy has been followed by the Brazilian authorities as part of their attempts to break the 'CDI culture' and extend the maturity of domestic debt: 'National treasury considers the foreign investor an important partner to the improvement and lengthening of the public debt's composition' (Kawall 2006). In this case the instrument utilised initially was inflation-linked bonds, a natural investment for Brazil's pension funds (see chapter 4). Attracted by high real interest rates, international investors were heavy buyers, encouraged by one international bank naming these securities the most attractive

¹¹¹ Loyal because the hedge needs to be in place while the swap is outstanding.

¹¹² Department Head, Turkish Treasury, interviewed 1 December 2005.

¹¹³ *Ibid.*

in all emerging markets at the beginning of 2006.¹¹⁴ As of October 2006, 68.9 per cent of foreign investment in Brazilian government bonds was in inflation-linked bonds, of which 43.4 per cent was in bonds of 3 – 10 year maturities, and a further 41.4 per cent was over 10 years.¹¹⁵ International interest was clearly far more skewed to longer maturities, but the pension funds, the natural domestic buyers, remained more cautious.¹¹⁶ As with Turkey, the strategy was to use international demand to encourage domestic investors. In a further, extreme, example, the Ukrainian domestic market, ‘foreigners are probably...80 per cent of the market. It creates the market. Without foreigners there is no market’.¹¹⁷

This is, therefore, a deliberate strategy of increasing internationalisation as a means to increase the maturities of the bonds that domestic investors will buy. This reduces policy autonomy, but only, if the policy is successful, on a temporary basis. Domestic investors are expected to increase their maturity of investment, with international investors serving as the catalyst for this process. In the meantime, policy autonomy is reduced:

[W]here you want to get to...is 30-year bonds, issued in local currency at reasonable interest rates, owned by your own investors...And once you’ve got there, you can be an Italy or Japan and have huge debt to GDP, and it’s financeable and nobody really cares...because you’re kind of immune to external prices. But, in order to get there in the short term, you have to take on more vulnerability to external events. Because it takes time to build that yield curve, out in the global investor base.¹¹⁸

In the case of Brazil, this vulnerability was demonstrated in May 2006, during global market weakness. Selling from foreign investors of inflation-linked bonds was not matched by domestic pension fund buying (because of their inactivity in the secondary market for reasons discussed in chapter 4). The Brazilian Treasury, on 24 – 26 May,

¹¹⁴ Bank proprietary trader, Brazil, interviewed 29 August 2006.

¹¹⁵ Source: National Treasury 2006.

¹¹⁶ ‘[T]he fact is the locals don’t have the balls to...go that long on the curve’ (bank proprietary trader, Brazil, interviewed 29 August 2006).

¹¹⁷ Emerging market bond trader, London, interviewed 18 October 2005.

¹¹⁸ Head of Research, fund management company, interviewed 14 February 2006.

intervened through ‘buy and sell auctions’, offering both to buy bonds from investors and sell them (National Treasury 2006: 22). This intervention served to stabilise the market through net purchases from investors, but was only possible because the authorities entered this period in a relatively strong fiscal position.

In both Brazil and Turkey, increased international interest in their domestic markets coincided with both a favourable global liquidity environment ‘pushing’ investment and economic policies popular with international investors serving to ‘pull’. The policy to use international investors to improve the domestic government bond market could only occur once policies had been followed that would meet their approval, suggesting reduced autonomy. The involvement of international investors is a trade off. Demand for government securities is increased, potentially reducing yields and extending the maturity of outstanding debt. However, the government’s autonomy from the policy preferences of those international actors is reduced.

Conclusion

When positioning international investors on the autonomy curve the data presented here largely agree with Maxfield’s 1998b distinctions, while also seeking to expand on them. Shorter-term investors such as hedge funds constrain governments to a greater extent simply because they will react more quickly to changing circumstances, compared to long-term investors such as pension funds. Hedge funds, therefore, just as their domestic counterparts, serve to move a country further to the right on an autonomy curve. In addition, these total return investors tend to be those with the broadest investment mandates, and therefore the greatest range of investment alternatives. They are also more likely to be able to express disloyalty by shorting government bonds, and to use leverage to increase their influence. In contrast, those investors following an index have reduced ability to trade actively, and may, in some cases, have an inability to exit fully the larger constituents of the index, so demonstrating loyalty unconnected to a government’s regulation. Pension funds are longer-term, patient investors. Such

investors serve to keep a country further to the left on the autonomy curve relative to total return investors, but still are more constraining on government policy than domestic mutual fund and pension fund investors.

Chapter 6

Conclusion

Introduction

This thesis is important to the understanding within international political economy of the relationship between financial markets and government policy autonomy. It is argued that a number of changes should be made in the way this relationship is considered. The first, supported by empirical evidence, is that domestic financial actors need to be given far greater emphasis. Second, the use of financialisation as the independent variable provides the means to combine both domestic and international actors within a single analytical framework, and further highlights the importance of the similarities between investor types across borders. The use of financialisation also allows consideration of the way investor activities change over time. Third, investors are analysed for their levels of loyalty to government debt – loyalty both enforced by regulation and inherent in the nature of particular investors – to show how financialisation and investor loyalty (and disloyalty) interact. Investor loyalty is then shown to be a key determinant of government policy autonomy, by allowing governments to borrow higher volumes of debt on a sustainable basis. The conclusions are summarised in an autonomy curve.

Chapter Structure

This chapter first outlines the autonomy curve, and discusses the main influences on the curve. These are the processes that result in the level of financialisation of the government bond market structure, in the financialisation of the investors in the market, and in the height of the autonomy curve. The chapter then discusses whether movement

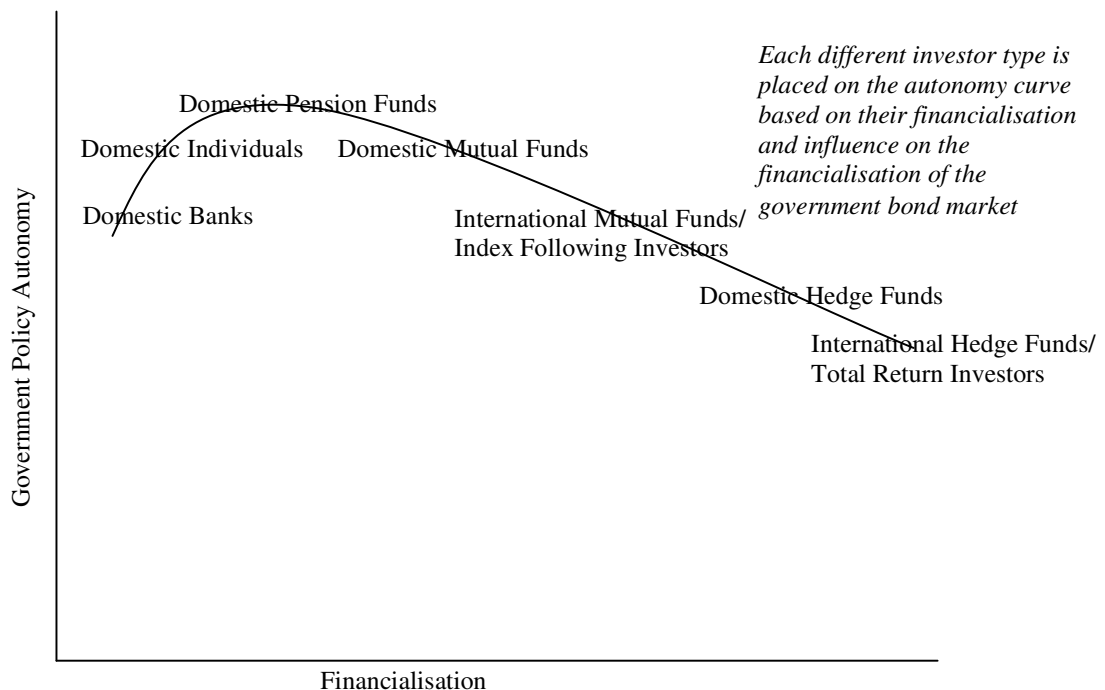
towards the left on the autonomy curve is possible or even likely. Conclusions are then drawn regarding implications of this study: first, for the use in the financial markets of Hirschman's conceptions of voice, exit and loyalty; second, for the study of financial markets in international political economy; third, for questions of government policy autonomy in the face of financial globalisation; and fourth, the implications for government policy towards the liberalisation of financial markets.

The Autonomy Curve

The autonomy curve can now be outlined in full (see Figure 1).

Figure 1.

The Autonomy Curve



As previously discussed, the overall financialisation of a government bond market is the result of two separate, but connected, influences on the ability to trade risk. The first is the financialisation of the government bond market structure, which influences the ability to trade in that market, and the second is the financialisation of the investors themselves. The overall financialisation of a government bond market is the result of the interaction between what is available to trade, and the ability of investors in the market to trade them. Each country's government bond market, therefore, can be positioned at a particular point on the autonomy curve, dependent on the dominant investors (i.e., which types of investors own the debt) in that market, and the level of financialisation of those dominant investors.

So, for example, the markets (both domestic and international) for Lebanese government bonds are dominated by a combination of (relatively unfinancialised) domestic banks and Lebanese individuals. Lebanon can therefore be placed near the left hand end of the autonomy curve. Turkish domestic banks are more financialised than their Lebanese counterparts, and less dominant in the government debt markets (though still significant), with other investor types (including international investors) making up the balance. There are no domestic hedge funds. The larger size of the Turkish markets also makes trading easier. As a result, Turkey should be placed more to the right along the autonomy curve than Lebanon.

The Brazilian government bond market differs from both Lebanon and Turkey. Domestic financial market actors are considerably more financialised, and include domestic hedge funds, investors that are not present in the other two case study countries. The market is large and includes the highly liquid Brazilian Mercantile and Futures Exchange (BM&F). In the international market (at least at the time of interviewing), the large size of the outstanding government bond issues made them very easy to trade, attracting the most financialised international investors, hedge funds. Therefore, Brazil is, of the three case study countries, the furthest to the right on the autonomy curve, and has the lowest autonomy from the policy preferences of

international investors. Other emerging market countries could similarly be placed along the autonomy curve, with most likely to be between Lebanon and Brazil.

Financialisation of the Government Bond Market Structure

The financialisation of a government bond market structure will be considered first, before discussing the different types of investor. The financialisation of the market structure is concerned with the financial instruments that can be traded and the overall infrastructure of the market. International hedge funds may have the capacity and investment mandate to trade futures on the Lebanese government bond market, for example, but if a futures market does not exist in a country, or if settlement systems make trading difficult, there will be little, if any, futures trading in that country. Clearly the establishment of such a market is not in itself sufficient; financial market actors must also want to use the market. Nor is a physical market or an organised exchange necessary for active trading, since many markets, including the market for international emerging market government debt, are ‘over the counter’. As the discussion of the credit derivatives market in chapter 2 showed, a market for government credit can also develop with little assistance from the government whose credit is being traded. Nevertheless, the importance of regulation has been recognised throughout this thesis.

In addition to regulation, a government can be, and very often is, actively involved in increasing the financialisation of its own bond market, by policies which make it easier either to access the market or to trade. Brazil has been particularly active in this regard. The opening of the market to direct investment in February 2006 has been discussed in chapter 5. The primary dealer system has also been revised to ensure a market making commitment¹ (as in Turkey²). Brazil has an organisation – Brazil: Excellence in Securities Transactions (‘BEST’) – a joint venture of a number of institutions, including Banco Central do Brasil and the National Treasury, specifically to encourage

¹ Senior official, Ministry of Finance, Brazil, interviewed 6 September 2006.

² Department Head, Turkish Treasury, interviewed 1 December 2005.

international investor involvement in the domestic securities market.³ Its publications highlight the 2002 reform of settlement procedures, amongst a range of attractive features of the Brazilian markets.⁴ A further example of making it easier to trade risk is ‘Treasury Direct’, allowing individuals direct access to the auctions of government debt (see chapter 3). Furthermore, the Treasury’s 2007 borrowing plan includes measures to increase the liquidity of the market (National Treasury 2007: 13). These are all examples of developing a market that is already well established; the government’s role is likely to be even more central in a situation where a market is in its early stages of development.

Private sector initiatives are also likely to be important in making it easier to trade (see Porter 2005 on international securities markets). The establishment of the BM&F, for example, was very much driven by the private sector, in the face of some official hostility in its early years,⁵ and the private sector is actively involved in ‘BEST’. Most important, financial market innovation comes almost exclusively from the private sector. The development of new financial instruments is a central part of the financialisation of government securities markets, improving access to markets and increasing trading. The clearest recent example of this in the international markets is credit derivatives (see chapter 2), but it is one of many. The presence of options, interest rate swaps, and the range of potential government bonds – across all maturities, fixed rate, floating rate and index-linked, etc. – all have an influence on the degree of financialisation. The size of the market as a whole is another factor: the Brazilian domestic market is more than twice the size of the Turkish, and more than twenty times as large as the Lebanese. The size of individual bond issues in the market, however, will also have a significant impact on the ability to trade. In the international market, Brazil’s largest bond, maturing in 2040, had an issue size of over US\$5 billion. Lebanon’s largest international bond, in contrast, is

³ See www.bestbrazil.org.br, accessed 13 June 2007.

⁴ www.bestbrazil.org.br/pages/publications/BrazilianCapital/Brazil-A_Country_with_Open_Arms.pdf, accessed 13 June 2007.

⁵ Senior official, BM&F, interviewed 1 September 2006.

under US\$2 billion.⁶ Independent of the ownership of an individual bond (see chapter 2 for how the ownership of Lebanese bonds further limits the ability to trade), a small issue size reduces the ability to trade risk. Three other factors will increase financialisation, all usually the result of government policy: first, a successful system of primary dealers – financial intermediaries committed to making markets – in government debt;⁷ second, settlement systems (i.e., systems which transfer ownership of securities and settle any cash payments) acceptable to the broadest range of financial market actors; and third, regulation that is also broadly acceptable (World Bank 2007; for further possible reforms, see Borensztein *et al.* 2007). The factors affecting the financialisation of the government bond market structure are mainly linked either directly to liquidity, one aspect of the ability to trade, or to the range of available instruments in the market, which also makes trading easier.

Financialisation of Investors

Without a sufficiently financialised government bond market structure, the level of financialisation of investors is irrelevant, and vice versa. The second influence on the financialisation of the overall government bond market, therefore, and the main focus of this thesis, is the financialisation of investors. Here, the important consideration is the relative influence of particular investor types, and the degree of financialisation of those investors. The degree of financialisation of individual investor types reflects a combination of both regulation and factors inherent in their nature as investors. Examples of the latter include the appropriate timeframe of investment, which varies across investors. Pension funds' greater proclivity for long term investment means they are likely to be less of a constraint on government policy autonomy than other institutional investors.⁸ Banks also have to match assets and liabilities, but their

⁶ Excluding the Banque du Liban Certificate of Deposit due 2015, which is US\$2 billion in size. www.audi.com.lb/stocks/fx_tbills2.cfm, accessed 22 June 2007. Certificates of Deposit rarely trade in the international market with the same liquidity as bonds.

⁷ It can be argued that primary dealers are not appropriate for smaller markets (Borensztein *et al.* 2007: 148).

⁸ The Brazilian example shows this will not necessarily be the case (see chapter 4).

liabilities, principally deposits, are generally more short term. They are therefore more likely to be shorter term investors. Mutual funds, both domestic and international, can invest over a range of timeframes, dependent on the investment strategy that is being utilised. Meanwhile, hedge funds, thanks to their leverage and stop losses, are far more likely to be the most short term investors. They will buy long maturity government bonds, but with no plans to be 'buy and hold' investors. The nature of pension funds and certain parts of banks' portfolios (the parts held in investment accounts) demonstrate significant loyalty. The conclusions here match Maxfield's (1998b) distinctions between short and long term international investors, and expand on those distinctions to cover domestic financial actors.

Domestic commercial banks can also have a loyalty to the government debt market that matches Hirschman's second conception, whereby an investor cares about the government bond market '*whether or not he stays on as a member*' (1970: 99; italics in original). The commercial banks in Lebanon and Turkey cannot fully exit the government bond market, as a result of the size of their holdings of bonds (relative to the overall size of the market). Domestic banks in all three case study countries also cannot exit their home economy. In addition, commercial banks are almost the only investors that are sufficiently large to be able to influence prices in the government bond market. They can be 'quality-makers' (Hirschman 1970: 99), with both the desire and the capacity to support the government bond market. Loyalty is evident in all three case study countries, with the main difference being in the ability to influence prices: relatively high in Lebanon and low in Brazil, with Turkey in between. The difference is the result of both the banks' relative size in the government bond markets and the financialisation of those markets (see chapter 2).

The volume of funds available to a market actor is also important. Transaction costs, and especially information costs, decline as the size of investment increases. High transaction costs are a disincentive to diversification, leading to a home bias amongst all investors. Investors globally have a tendency to invest in their home market to a far

higher extent than theories of optimal portfolio diversification would suggest (see chapter 1), but the extent of home bias will vary across investors. This home bias is the main reason why in each investor type, domestic investors are seen as less financialised and less constraining on government policy autonomy than their international counterparts. This difference is least apparent between domestic and international hedge funds, because a domestic hedge fund could maintain its home bias while being short government securities. Home bias therefore does not have to result in loyalty, but could also result in disloyalty.

This ability to express disloyalty might be taken to suggest that both domestic and international hedge funds should be placed at the same point on the autonomy curve. The differences between Brazilian and international hedge funds in their investment strategy are minor (see chapter 4). Two important differences remain, however, that support a differentiation. First, home bias is, in part, enforced by government regulation. An example (albeit of a regulation that can be circumvented) is that Brazilian hedge funds can invest a maximum of 10 per cent of their assets outside the country. Such ‘enforced loyalty’ is limited if the investor in question can simultaneously adhere to the regulation and express disloyalty. Nevertheless, there is potential for greater regulatory control on domestic investors’ activities, so it is appropriate to see domestic hedge funds as potentially less able to trade risk. Second, there is not perfect symmetry between the ease in taking a long position and a short (Rubinstein 2004; MacKenzie 2006: 270). For example, there are difficulties such as the need to borrow bonds (see chapter 2). Furthermore, whereas a long position will result in an investor receiving the interest on the bond if the market does not move, an investor with a short position will usually lose money if the market does not move.⁹ These difficulties mean that investment that remains ‘at home’ is, *ceteris paribus*, more likely to be taking long positions. The ability of a financial market actor to take a short position in the government bond market, and thereby to express disloyalty, still represents a significant difference in investor activity,

⁹ A short position will ‘cost’ the difference between the interest on the bond sold and the interest on the cash received from the sale.

and an important reduction in government policy autonomy. Nevertheless, it is appropriate to see domestic hedge funds as being to the left of their international counterparts on the autonomy curve.

In assessing the overall financialisation of a government bond market, it is the relative influence on the market of different investor types which is the determining factor. In Figure 1 the different investor types are placed at fixed points on the autonomy curve. This is intended to highlight the influence of each type of investor on the overall financialisation of the government bond market. Therefore, a market in which all the investors are commercial banks will have a very much lower level of financialisation than one in which the investors are, for example, divided more equally between commercial banks, individuals, pension funds and hedge funds. In markets with any degree of financialisation, it becomes impossible to determine with absolute confidence the exact 'relative influence on the market' of particular investor types. The necessary data to establish the range of influence do not exist, given that even the name of an institutional investor may not reveal which type of fund is the final investor.¹⁰ Some of the data presented for the ownership of government bonds in the case study countries (see Appendix B) give a partial answer to the question of which investor types are important, and the interview data in this thesis provide considerable further detail. A full classification of different markets must, however, await further research. Nevertheless, it is clear that the government bond markets of the case study countries, including the international debt markets, have very different characteristics from one another that are largely a reflection of the different investor types that predominate. Brazilian and Lebanese US dollar denominated international debt markets trade in very different ways. This difference remains important regardless of the inadequacy of the data in precisely determining the relative influence of types of investor.

¹⁰ Even the word 'final' is misleading, given funds are obviously themselves owned by other investors.

The Changing Nature of Investors

Investors are categorised by types in this thesis, and the focus is on the implications of the differences between investors. However, the study has also emphasised a process which has received less attention in the academic literature, but is also central to the increased financialisation of any market. This process is changes in the financialisation of the investors themselves; investors become more able to trade risk as their capacity increases and their investment mandates and regulation become more flexible. Both serve to move particular investor types, and thus an overall government bond market, to the right on the autonomy curve.

The use of investor types is the most appropriate level of aggregation for the analysis undertaken here (see chapter 1). However, its limitations must be recognised. Different investment activities exist within the same organisation. There are considerable differences between the investment accounts of commercial banks, buying government bonds to hold for up to 30 years, and the same banks' proprietary trading activities, able to express disloyalty by shorting government bonds in a similar way to hedge funds (see chapter 2). Similarly, fund management companies that have specialised in index-benchmarked funds are now establishing hedge funds. Another complicating factor in the analysis is that increased financialisation of certain institutional investors has allowed investment in other institutional investors. Pension fund investment in specialist emerging market fund managers and hedge funds is one example (see chapters 4 and 5). The use of investor types is nevertheless the most appropriate approach, and recognition of the changing nature of these investor types, through their increased financialisation, is important to an analysis of the increased financialisation of a government bond market.

The volume of funds controlled by an investor will change over time, reducing (or occasionally increasing) transaction costs and increasing (or decreasing) financialisation. However, investor activity is not limited only by capacity, but also by what investments are permitted. The latter is the result of regulation and, for an institutional investor, the

investment mandate under which the investor operates. Regulation and issues surrounding liberalisation have received less attention in this study than has generally been the case in some studies of financial globalisation (e.g., Porter 1997, 2001). As with technological changes, the aim was not to minimise the importance of liberalisation, but to focus rather on less-explored areas. The Banque du Liban's tight control of the domestic financial markets, and the markets' financialisation, should not be underestimated. Nevertheless, the evidence presented here clearly demonstrates a link between financialisation and the government's ability to control the government bond market. Furthermore, much of this financialisation is linked to innovation, often originating abroad. Therefore, while liberalisation of the government bond market and of the domestic actors within the market is part of the explanation for increased financialisation, it is only a part.

Changes in investors' internal controls are also significant. This represents a crucial area of increased financialisation, and occurs in two distinct areas: direct investment and investment in other institutional investors. This process can be seen not only in institutional investors investing in other institutions, but is also very obvious in the greater latitude for emerging market fund managers to invest in instruments other than foreign-currency government bonds, including moving into local currency government bond markets and such innovations as credit default swaps. In the case of index-benchmarked investors, the development appears to be to move further away from being measured relative to the index, potentially reducing the loyalty to some of the larger credits (including Brazil). Change can also be seen with domestic investors, most obviously in the differences in the activities of commercial banks in the case study countries. Further change is also expected, for example, in pension fund activities in Turkey, allowing greater latitude in investments other than Turkish government bonds.¹¹ All these changes serve to increase the ability to trade risk, and move investor types to the right on the autonomy curve.

¹¹ Department Head, Turkish Treasury, interviewed 30 November 2006.

The Height of the Autonomy Curve

The discussion above has concentrated on those factors which influence the movement along the autonomy curve as a result of increased financialisation of a government bond market and of the investors within it. However, regardless of movements along the curve, a government's policy autonomy is also dictated by the height of the autonomy curve on the y axis. The higher the overall curve is, the greater the government's policy autonomy will be. What follows should not be taken as an exhaustive list of factors that influence the height of the curve, but a discussion of the most important.

As discussed above, a government's borrowing requirement will obviously be of central importance to the height of the autonomy curve. A government with no borrowing requirement (either for current spending or for the repayment of prior borrowing) would have total policy autonomy, regardless of the financialisation of the market. The autonomy curve would be a flat line across the very top of the graph. As Appendix B shows, government international borrowing varies greatly across the emerging market countries. The combination of the height of the curve and where a country is positioned on the curve means that it is ultimately not the government's borrowing requirement that determines autonomy, but the borrowing requirement relative to the capacity of the most loyal investors to provide that financing. A government that has a borrowing requirement that can be met by domestic pension funds, for example, would have no need (from the point of view of its borrowing) to attract international, or allow the development of domestic, hedge funds. The case study countries vary greatly in the assets of banks and pension funds relative to both GDP and government borrowing (see chapters 2 and 4), with Lebanon having the highest debt-to-GDP ratio, but the lowest ratio of borrowing relative to the capacity of loyal investors to provide financing.

Both the relative strength of push versus pull factors, and the absolute strength of push factors (such as US interest rates) will have an impact on the height of the autonomy curve (Maxfield 1998b adopts a similar approach). At the extreme, if international

investor flows are entirely the result of push factors, government policy autonomy, and the autonomy curve, will be very high. Flows will be the result of exogenous factors, regardless of government policy choice (Maxfield 1998a, 1998b: 73; Haley 2001: 76). The only constraint on autonomy, and the reason the autonomy curve will not again be a flat line at the top of the graph, is that some domestic investors will react to government policy choices in the same way as international investors do.¹² In the more likely scenario where push and pull factors are both material, if to varying degrees, the absolute strength of push factors will also determine the height of the autonomy curve, as stronger global liquidity and low developed world interest rates will serve to push more international flows to a country, even if government policy remains unchanged.

Credit ratings may also serve to influence the height of the autonomy curve. In a similar fashion to Mosley's (2003) view of investor policy concerns being more broad in emerging markets than in developed, it may be that the weaker the credit, the more closely government policy will be examined. This appears to be the case as far as politics is concerned: 'The weaker the credit, the more important the politics' (hedge fund manager, quoted in Hardie and MacKenzie 2007b). The stronger the credit rating, therefore, the greater the government's policy autonomy, and the higher the autonomy curve. It is recognised that there is circularity here; high credit ratings require a particular set of policies. '[T]he agencies put a price on the policy choices of governments' (Sinclair 2005: 10). However, the inclusion of ratings as a factor in the height of the autonomy curve also highlights the fact that governments' autonomy can frequently be constrained by the situation they inherit, such as the overall level of government indebtedness.

Although it has not been discussed in any detail in this thesis, technology must be recognised as an important contributor to increasing investor capacity (Cerny 1994; Strange 1997a; Aglietta and Breton 2001), even if an approach to financial globalisation

¹² Although note that, for domestic investors who can invest freely abroad, the push factor of low US interest rates will serve to keep investment in the domestic currency.

that tends toward technological determinism (especially those linked to improved communications) should be treated with caution (Hirst and Thompson 1999: 37). The increased technological capacity of investors, both through their own technology and in the services offered to them, increases the ability to trade risk in a number of ways. Financial modelling, either self-designed or bought from outside, is central to the trading of more complex financial instruments (Aglietta and Breton 2001). Information gathering has been made increasingly easier through its electronic delivery, making issues surrounding the choice of what information to focus on far more pertinent than those surrounding any lack of information (Abolafia 1996; Hardie and MacKenzie 2007a and b). Technology has also decreased the costs of trading through reduced transaction costs generally. The lack of focus on these issues in this thesis is more a recognition of technology having been dealt with elsewhere (for example, O'Brien 1992; Castells 2000; Frieden 2006: 394; Dicken 2007: 73) than an attempt to deny their importance. Technological advances reduce transaction costs, thereby increasing the ability to analyse and trade risk. This increased financialisation acts to reduce government policy autonomy.

One area of technological development has been extensively considered in this thesis. This is financial innovation, the use of new financial instruments and new investment strategies which generally serve to increase financialisation by making the trading of risk easier. Innovation in financial markets is of course nothing new. Ubide (2006) dates the first recorded 'hedge fund-style investment' (actually a call option on the use of olive presses) to 2500 years ago, and the first hedge fund was established in 1949 (Chadha and Jansen 1998; Ubide 2006). However, the question remains as to whether innovations such as hedge funds and credit default swaps have changed the nature of government policy autonomy, and a government's ability to reverse financialisation. Was Susan Strange's (1996: 4) view, that 'the impersonal forces of world markets...are now more powerful than...states', wrong or prescient? I will return to this question, which is clearly not one only of technology, below.

Technological change is covered in this thesis as one of the factors which influences the overall height of the autonomy curve against the y axis. It serves to increase the financialisation of domestic and international investors alike. It also makes it easier for financial intermediaries to offer their services to a wider range of clients. The financialisation of different types of investors is influenced by technology in different ways. For larger institutional investors, for example, the capacity of their own very large computer systems is crucial, whilst for individual investors low cost information may be the most important. However, the underlying processes are similar, and therefore technology is seen as an influence on the height of the curve rather than as moving investors by differential amounts along the curve. While this appears to be generally the more appropriate approach, the availability of certain technology could result not only in differences between individual countries, but could also widen the gap between domestic and international investors.

The size of an economy will also have an impact on the height of the curve. Larger economies would be expected to have larger banks and institutional investors, who would have greater capacity to diversify their investments. The larger size of the market would similarly attract international financial actors (Sobel 1999: 131¹³), including international investment banks and those offering investment services to wealthier individuals. Therefore, whilst changes in the size of the investors within a country would serve to move those investor types to the right on the autonomy curve, because they become more financialised, the size of the economy has an influence on the overall height of the autonomy curve.

The autonomy curve will not meet the x axis, regardless of the influences on the curve's height discussed above. Governments always retain some degree of autonomy. The view that 'the impersonal forces of world markets...are now more powerful than the states to whom ultimate political authority over society and economy is supposed to belong' (Strange 1996:4; see also Strange 1998) depends on the cost of the various alternatives

¹³ Sobel uses population size as a proxy for market size.

to meeting the policy preferences of international financial actors being too high to be seriously contemplated. If that alternative is permanent autarky, this may be the case. In government bond markets, however, one possible government policy will mean some autonomy is always maintained: default (see Nunnenkamp and Picht 1989 for analysis of the possibilities of ‘willful [sic] default’). Evans (1985) recognises the ‘agonies’ of countries in default, and Eaton *et al.* (1986) highlight the importance of reputation as a disincentive for borrowers to default, but both are writing of default to commercial banks in the ‘lost decade’ from 1982 (see also Lipson 1981).¹⁴ Recent experience of default to bond market investors, although also resulting in severe economic contraction, has seen investors face coordination difficulties (Cooper and Momani 2005), and international investors’ interest in buying new bonds (and economic growth) return relatively quickly (Datz 2004).¹⁵ Furthermore, as with investors’ ability to exit, the possibility of default may give countries some influence on creditors (Krasner 1985: 36). Therefore, even a government bond market dominated by international hedge funds (or even more financialised investor types not yet conceived) does not result in a total loss of government policy autonomy. This is represented in figure 1 by the curve flattening towards the right hand end.

Can a country move to the left on the autonomy curve?

One further question needs to be addressed regarding the autonomy curve – the nature of movement along the curve. It is clear from the discussion immediately above that the overall curve can move both up and down. A move in US interest rates or a change in a country’s credit rating could serve to change its height in either direction, for example. A default, by drastically reducing the need to borrow to refinance existing debt, could move the curve upwards. But what about movement along the curve? This question is similar to the long-standing debate within IPE as to the potential reversibility of capital

¹⁴ In contrast, also considering the period of bank loans, Lindert and Morton (1989) conclude lenders ‘do not punish governments with a prior default history’.

¹⁵ Although Philip (2003: 107) speculates that Latin America may suffer from a ‘lenders’ bias’, the result of a history of over-indebtedness and default.

mobility (e.g., Helleiner 1994, 1996; Pauly 1995; Cohen 1996). There is a danger that the preceding chapters can be read as arguing that an inevitable move to the right along the curve is occurring, slowed by government regulation but never stopped or reversed. Financial market actors can be seen as inevitably gaining more freedom to trade risk, prompting increased financialisation of the government bond market and steadily reduced government policy autonomy. The expectation would be that, in time, all countries end near the far right of autonomy curve. It appears clear that, as outlined in this thesis, there are strong factors that increase financialisation, many, such as technology and innovation, outside government control, and which governments cannot reverse. Credit default swaps, for example, will not be ‘uninvented’. Therefore, absent other influences, movement to the right along the autonomy curve is to be expected. However, it would be wrong to see this thesis as an argument for a necessarily sequential development of government bond markets and investors. A ‘pecking order model’ is not appropriate (Borensztein *et al.* 2006: 5).

Moreover, there are ways in which there can be movement to the left on the curve, both as a result of government actions and independent of government. High levels of financialisation are not simply ‘a fact of life’ (Thrift 2001: 377; Froud *et al.* 2000:104 disagree with Thrift). Most obviously, as far as government action is concerned, even if financial innovations cannot be ‘uninvented’, their use can be limited. Capital controls can be reimposed. Despite the increasing ability of financial market actors to circumvent such controls, they at a minimum increase the cost of moving capital across borders. Malaysia’s response to the 1997 Asian crisis is a recent example (Cohen 2000: 198; Eichengreen 1999: 56). As with a decision to default on government debt, the decision for governments is between possible short term advantage and the potential for long term increases in the cost of attracting international capital (including to the government debt market), or ‘reputation risk’. There is still considerable debate regarding both the short term and long term impact of the Malaysian decision (Krugman 1999; Edison and Reinhart 2000; Dornbusch 2001; Kaplan and Rodrik 2001; Athukorala 2003; Tamarisa 2004), but there is little doubt that it allowed Malaysia the autonomy to pursue (at least

temporarily) a heterodox economic policy. Another measure also implemented during the Asian crisis is to make hedge fund shorting more difficult by making borrowing more difficult. Chapter 2 outlined a private sector attempt to do this in Turkey in 2001, but in Thailand in 1997, official intervention to limit lending Thai baht outside the country temporarily ‘kicked our [the hedge funds’] butt’.¹⁶ This action by the Thai authorities represents a decrease in financialisation, by limiting the ability to trade. Given the subsequent experience of Thailand, ‘temporarily’ represents an important caveat, but such restrictions are one of the possible limitations on hedge fund activity raised by Eichengreen and Mathieson (1998a: 1). Developed world regulation of banks, pension funds and mutual funds leads one commentator to conclude: ‘Stage by stage, today’s asset management industry is becoming dominated by regulators’ (Riley 2007). ‘Re-regulation’ (Cerny 1993b) does not have to be in the direction of greater financialisation. Regulation that limits (or continues to limit) the financialisation of pension and mutual funds in the domestic markets would have a substantial impact (see chapter 4). These measures do not have to be temporary, but the long-term success of at least some regulations is likely to require cooperation from loyal investors. The Lebanese banks’ long-standing unwillingness to lend securities has limited the ability to short in that market (see chapter 2), for example.

It is not inevitable that the most financialised market actors will increasingly dominate markets. When considering changes in the investors in government bond markets, the growth of hedge funds in particular should not be seen as inevitable. Hedge funds’ main attraction for their founders is the high fees they typically charge relative to traditional fund managers (Chadha and Jansen 1998: 34; Crockett 2007: 20); for investors, it is the expectation of higher returns and the ability to maintain them in a weak market. Competition may erode fees for all but the most successful funds,¹⁷ and the attraction of hedge funds for investors may be reduced if they fail to meet expectations either for return or risk diversification. The Managing Director of the IMF is among those who

¹⁶ Stanley Druckenmiller ‘Soros’s chief lieutenant’, quoted by Blustein 2001: 72.

¹⁷ There is little sign of this to date (*Financial Times* 27 April 2007: 3).

have cast doubt on ‘their contribution to risk diversification’ (Rowe 2007). Hedge funds starting ‘long only’ funds removes the element of disloyalty, and hedge fund companies themselves being listed may result in them becoming more like traditional fund managers (e.g., *Financial Times*, 25 June 2007: 1). Lower levels of leverage (borrowing) would reduce hedge funds’ influence.¹⁸ Many of these potential developments can be no more than speculation at present, but it is important to recognise that although the enormous growth of hedge funds represents a significant change in the financial markets, it is by no means inevitable that hedge funds, as currently active, will increasingly be the dominant investor type. Indeed, some interviewees noted a reduction in the activities of the largest hedge funds in the emerging bond markets in recent years (see chapter 5).¹⁹ Furthermore, there have been (so far unsuccessful) attempts at increased international regulatory control of hedge funds (*Financial Times*, 22 May 2007: 6). Even without regulatory controls, if hedge funds really are focused on exploiting market discrepancies, their activities may reduce their own opportunities for future profit by reducing those anomalies (Grossman and Stiglitz 1980). The growth of hedge funds may lead to a permanent increase in the financialisation of financial markets, but the institutions that emerge as the dominant actors may not be as leveraged or have as broad investment mandates as some existing hedge funds. This would limit the move to the right along the autonomy curve.

Two facts regarding investment remain highly unlikely to change, and both slow progress toward increasing financialisation. The first is that investment will continue to be made for different purposes, and subject to different constraints. Pension funds can always be expected to invest with the ultimate aim of meeting long term liabilities, for example, and the growth of pension fund investment remains as marked a part of the current financial markets as the growth of hedge funds (Borensztein *et al.* 2007: 152).

¹⁸ Regulators, such as the New York Federal Reserve, have approached this by focusing on lending to hedge funds (*Financial Times*, 3 May 2007: 10).

¹⁹ Head of Research, fund management company, London, interviewed 14 February 2006; Head of Emerging Market Bond Trading, investment bank, New York, interviewed 17 May 2006.

Individuals, meanwhile, will always face higher transaction costs than institutions.²⁰ Both these investor types, as others, appear likely to see increased financialisation, and there may be changes in their relative importance – for example as investment is increasingly institutionalised – but differences between them will remain. These differences will prevent a move entirely to the right on the autonomy curve. The second factor will have the same limiting impact on financialisation. This is the fact that, even in an increasingly globalised financial system, differences remain between domestic and international investors. For all the reasons discussed in this thesis, we have not reached ‘the end of geography’ (O’Brien 1992). Again, the movement appears to be generally toward increased financialisation, to the right on the autonomy curve, but there appears no reason to expect the home bias in investment to disappear in the foreseeable future. A number of reasons why home bias is likely to remain higher for developing countries are highlighted above (see chapters 2-4).

Investors will therefore never all be completely financialised. There will always be, in the nature of (nearly all) investors some constraints that, even absent government regulation, limit their ability to trade risk. Only a limited group of investors will be able to express disloyalty, and many will continue to demonstrate varying degrees of, and motivations for, loyalty. However, it must also be recognised that the movement in recent years has been towards the right on the autonomy curve, as investors become more financialised, and that the cost of reversal increases as this occurs. Financialisation, the move to the right on the autonomy curve, is not inevitable, but it has been the general movement in the case study countries.

The Implications of the Autonomy Curve

In concluding this thesis, four implications of the autonomy curve will be discussed: First, implications for the use in the financial markets of Hirschman’s conceptions of

²⁰ The cost of investment for individuals has clearly declined substantially with technological advances. However, the same is true of institutions, and institutions are likely to enjoy continued economies of scale.

voice, exit and loyalty; second, for the study of financial markets in international political economy; third, for questions of government policy autonomy in the face of financial globalisation; and fourth, the implications for government policy towards the liberalisation of financial markets.

Hirschman's Voice, Exit and Loyalty

Ideas of voice and exit are ubiquitous in discussions of financial markets (see chapter 1). Typical of their use is Santiso's (2003: 23) conclusion that voice is difficult and exit '(nearly) always available'. Loyalty is rarely considered, and when it is, is either dismissed as almost non-existent (e.g., Santiso 2003: 24) or only important if enforced by government regulation (Cohen 1998). This thesis has taken a different approach, and one, I have argued, more suited to the analysis of modern financial markets. Voice has not been directly considered in this study. The international investors interviewed all agreed that they would never attempt to utilise voice with governments as an alternative to exiting a market. Interviewees either felt it was not their role to make representations to government regarding policy (aside from specifically regarding borrowing strategy such as which market to access or the preferred maturity of borrowing), or felt that even if they did make such representations, it would have no impact. There was also general agreement that even if it could have an impact, voice took too long to achieve policy change to represent a viable alternative to exit (Santiso 2003: 23). Amongst domestic investors, only Lebanese banks attached any importance to their ability to voice concerns as a disincentive to exit. Voice, therefore, should be seen as playing a relatively minor role in government bond markets.²¹

Loyalty, on the other hand, is given far greater consideration in this study than is usual. Differences in loyalty between investor types are central to the impact of financialisation on government policy autonomy. The more loyal an investor, the greater government

²¹ It may well be the case that voice is more important elsewhere in financial markets. 'Activist' hedge funds, for example, which buy equities and then agitate for change at a company, have an investment strategy largely predicated on voice being effective.

policy autonomy, and the more able an investor to trade risk, the less loyal that investor will be. Beyond this, I have made a number of important points regarding the conception of loyalty in government bond markets. The first is that it is inadequate to see loyalty only as ‘enforced’ by government regulation. Loyalty related to the cost of exit is central to this study, but government regulation is only a part (albeit a very important part) of this loyalty. A complete analysis of loyalty must also include loyalty that is the result of the nature of the investor. Transaction costs create high costs of exit for individual investors, regardless of capital controls, for example. Pension funds are long-term investors in local currency debt, because of their liabilities, and in certain, larger countries, index-benchmarked institutional investors will still own bonds they expect to default. The inability to exit fully, even after selling bonds, creates for many domestic banks a situation where they care about the country even after exit – selling their bonds – and this combines with their ability to be ‘quality-makers’ to influence their behaviour (see chapter 2). This behaviour can include slowing the financialisation of a market, as with the Lebanese banks’ refusal to lend their bonds.

In addition, Hirschman’s conceptions of loyalty need updating (in the context of financial markets) to take account of shorting. As a result primarily of the recent growth of hedge funds but also through bank trading activity, short selling is now far more significant in financial markets than when Hirschman published (a work not specifically about financial markets) in 1970. Taking a short position, selling a security one does not already own, is clearly not exit; nor is it the same as retaining an investment. The investor retains an interest in the performance of the security, but it is an interest in the price falling. I have termed this disloyalty. The ability to express disloyalty represents a significant increase in financialisation in a government securities market, and reduction in government policy autonomy. It could, arguably, justify a downward step in the smoothly-sloped autonomy curve in figure 1. Investors that can short exert significantly more downward pressure on government bond prices, and therefore upward pressure on the government’s cost of borrowing. The fact that those investors able to short are often also those investors that can use leverage to increase those short positions makes them

even more influential. Of course, a short position must be ‘covered’ (i.e., the bonds originally sold bought back) at some unknown point in the future, but by that time the damage may have been done, especially in a crisis situation. For these reasons, Hirschman’s ideas, while remaining important, should be updated to voice, exit, loyalty and disloyalty, when applied to modern financial markets.

Financial Markets in International Political Economy

This thesis can be seen as a response to two separate calls for further research in international political economy. The study also suggests a framework, the concept of financialisation, for this research. The first call is for ‘the disaggregation of international financial asset holders by product and investment objective’ (Maxfield 1998b: 70; also Sobel 1999: 206). Maxfield made considerable progress in following her own suggestion and in demonstrating its importance (see chapter 1). This study has sought to provide more detail to that disaggregation, in particular by assessing the impact of further different investor types, banks, individuals and mutual funds. The aim is to present a fuller picture of the actual investors that buy emerging market government bonds. The analysis presented here cannot be exhaustive; no level of aggregation in financial markets can. This study, for example, does not consider insurance companies (although they can be seen as very similar to pension funds [Maxfield 1998b: 72]), and only briefly discusses international individual investors. The data presented here do, however, demonstrate the range of investors, and the importance of this variety.

The most important addition to Maxfield’s disaggregation in this study is the far greater attention given to domestic investors. This responds to a second gap in IPE research, on domestic capital (Sobel 1999: 206). The empirical data presented above reinforces the widely-recognised dominance of home bias and domestic capital, including in emerging market countries (see chapter 1). The purchases by domestic investors of international bonds suggest that this dominance may even be understated. This study has highlighted that clear differences remain between domestic and international financial market actors,

even while supporting the view that those differences have been reducing (Cerny 1993; Maxfield 1997). Cohen (1996: 288) speculates, '[o]ne key [to understanding the nature of financial market constraints] might lie in the distinction between national and transnational capital'.²² In addition, this thesis has shown how the domestic and international financial markets can be analysed within a single framework.

This framework is the concept of financialisation, a measure of the ability to trade risk. The use of financialisation also to analyse differences between domestic and international investors has allowed a more nuanced approach, which demonstrates how these differences vary according to the investor type considered. This framework allows a classification of investors that can take account of their variety, and places their activities with regard to their constraint on government policy. The use of financialisation as the independent variable also allows due consideration of processes of change within investor types. A static conception of, for example, commercial banks is inadequate, as chapter 2 demonstrates. The nature of change is also seen clearly in chapter 5, concerning international institutional investors, with examples including pension fund investment in hedge funds and the increasing latitude in index-benchmarked investment mandates. These changes, taking place at the level of single institutional investors, can be shown to have an impact on government policy autonomy as part of a process of financialisation. Furthermore, the use of financialisation, with its concentration on changes in the ability of financial market actors to trade risk, allows consideration of the widest possible range of influences on the behaviour of financial market actors, including questions of regulation and liberalisation, of technological advances (including financial market innovation), in addition to investors' internal controls. It is therefore possible to consider a far wider range of variables than has been generally the case in international political economy's studies of financial markets.

²² Cohen suggests this distinction 'could help to explain observed differences in pressures for convergence at the sectoral level'.

Government Policy Autonomy and Financial Globalisation

What then are the implications of this study for emerging market government policy autonomy in the face of financial globalisation? It must be noted, as discussed in chapter 1, that the use of financialisation, and not financial globalisation, as the independent variable in this study means that the approach to the debate regarding government policy autonomy and financial globalisation is somewhat tangential. This lack of a direct consideration of financial globalisation is compounded by a more specific definition of financialisation than Epstein (2005b: 3). Nevertheless, while maintaining the view that financialisation is the more appropriate variable, the analysis presented here allows important points to be made regarding what has until now been the more general debate within IPE. The whole range of opinions on this question can be found within IPE (see chapter 1). This section will be confined to the specific observations that can be made as a direct result of the analysis presented in this dissertation. The disaggregation of a particular type of portfolio capital, that invested in government bond markets, can only form a small part of any broader analysis of the impact of financial globalisation, but the ability of governments to finance themselves remains central to their autonomy, and the issues raised here can also be generalised to some questions regarding financial globalisation more widely. This study has focused extensively on the actual workings of financial markets, and the data presented here allow consideration of the processes driving financialisation. This has an influence on any consideration of ‘how did it happen?’ (Cohen 1996: 272); on the existing extent of emerging market government policy autonomy; and third, on the connected question of whether financialisation is reversible, or ‘what can governments do about it?’ (*ibid.*: 289).

The implications of this thesis for the question of the processes driving financialisation are strongly connected to the arguments for considering financialisation rather than globalisation, capital mobility or internationalisation as the independent variable in the analysis. The crucial variable that has an impact on government policy autonomy is the ability to trade risk. International capital mobility is an important part of this capacity,

but the ability of a domestic financial actor either to exit or express disloyalty is not necessarily contingent on capital controls. An investor in government debt can effectively 'exit' by hedging a position, or gain from a market deterioration if s/he is short. As discussed previously, the fact that this could be done in Brazil (if sometimes imperfectly) but not in Lebanon is the important variable, rather than the fact that Lebanon has few controls on capital movement but Brazil retains some (reducing) level of control. Similarly, international investors could enter and exit (or indeed express disloyalty) in a highly financialised market such as Brazil, provided they have sufficiently broad investment mandates, at relatively low cost, despite (now removed) controls on their entry. Controls exist in Lebanon, but equally important is the fact that domestic banks do not see it as in their interests to assist financialisation, especially the expression of disloyalty. In crisis situations in Turkey, domestic banks have felt similarly, but lack the dominance of a more financialised market.

Financial market actors should not be seen, therefore, as necessarily being homogeneous in their interests, as has tended to be the case in sectoral-based interest group analysis of government policy (e.g., Frieden 1991a, 1991b). It is clear from this analysis that it is not only 'protected financial sectors' (Haggard and Maxfield 1996: 209) that can have an interest in more limited financialisation: banks, pension funds and (potentially, given their inability to exploit that financialisation) individual investors may also have such an interest without being protected. The activities of banks are only one example: the preferences of the Brazilian pension funds for government bonds whose interest payments would match their liabilities, rather than increased market liquidity, is another (see chapter 4). It might be argued that the disaggregation applied here goes beyond what can be analytically useful. However, since in many emerging market countries it is the more loyal investors who remain dominant (to a degree obscured by much of the data on international borrowing), it is necessary to disaggregate to this degree.

The implications of this emphasis on financialisation for any consideration of the important processes involved are therefore to suggest that a number of important areas

have been underemphasised at the expense of considerations of regulatory and technological changes that have influenced internationalisation. While this different focus is in part a result of the greater emphasis on domestic financial market actors in this study, it also suggests a difference in focus when compared to an emphasis on processes of liberalisation at a domestic level (e.g., Stallings 2006). What investors are able to do under their investment mandates, and as a result of the available market instruments and liquidity, is an important contributing factor to the process of financialisation, and therefore to government policy autonomy. These factors point to government policy options regarding financialisation – what governments can do about it – in the more technical area of the workings of financial markets and investors.

In considering the second question, regarding the extent of emerging market governments' policy autonomy, the issue raised in this study is familiar: have recent developments in financial markets meant that there has been a fundamental change in the relationship between states and markets? At one level there has undoubtedly been a significant change. It is unlikely that when Pauly (1995: 373) concluded that 'states can still defy markets',²³ and Helleiner (1994, 1996) argued that governments could reverse the liberalisation process they had started, either had heard of a credit default swap.²⁴ Outstanding CDS were US\$34,500 billion at the end of 2006 (*Financial Times*, 19 April 2007: 1). The last ten years have undoubtedly seen a substantial increase in financialisation in developed countries, and it has mainly been in the areas of investment mandates and financial innovation, not regulation. Such financialisation has been causing concern from some surprising observers, including the Managing Director of the IMF (Rowe 2007), and the New York Federal Reserve (*Financial Times*, 3 May 2007: 10).

The debate regarding government policy autonomy and financial globalisation has mainly been about the relationship between these two variables in industrialised

²³ Although for Pauly this is a lesson of 1914, suggesting the costs may be worth bearing only *in extremis*.

²⁴ I base this supposition rather presumptuously on the fact that, working in the international debt markets at the time they were writing, I had not.

countries. Part of this debate is whether international capital mobility should be seen as 'an exogenous structure that irrevocably binds societies or their states' (Pauly 1995: 385; he warns against so doing). This study however is concerned with emerging market countries. For them, international capital mobility is increasingly just such a structural constraint. For emerging market countries, the world is significantly, and increasingly, as their governments find it as regards the financialisation of their government bond markets. This situation is because decisions taken elsewhere mean investors can leave their (mainly industrialised) home countries as they choose; increasingly financial innovation and less onerous investment mandates have combined to increase the ability of investors to cross borders, regardless of the wishes of emerging market governments. If international investors wish to enter a country, increasingly (and at increasingly lower transaction costs) they can. For emerging market governments, the prospect of collective action at the international level to limit capital flows into their markets appears remote unless industrialised countries (and in particular the United States and United Kingdom) deem such action in their interests. The only possibility of slowing financialisation, therefore, is unilateral action, which appears likely to have to be focused on a dual strategy of encouraging the most loyal investors, particularly individuals and pension funds (and ensuring they remain loyal), and preventing markets becoming attractive to the most financialised investors. These financialised investors include domestic hedge funds. Broadly speaking, the more financialised a government bond market, the more attractive it will be to the broadest range of investors, and particularly the more attractive it will be to those investors with the lowest levels of loyalty, and the potential for disloyalty. Factors inherent in the countries themselves and the investors are important to financialisation but government policy towards that process remains important.

Across many of the emerging market countries, that government policy has been very much towards increasing the financialisation of the domestic government bond market, making them more attractive to international investors and increasingly easy for domestic investors to trade. Many of Brazil and Turkey's policy initiatives have already been discussed. Even Lebanon is participating in an IMF and World Bank pilot

programme ‘to design relevant reform and capacity-building programs’ in the domestic debt market (World Bank 2007). An extensive literature exists regarding the (seemingly ambiguous) linkages between financial globalisation or integration, growth and consumption volatility in developing countries (for surveys, see Prasad *et al.* 2004; Kose *et al.* 2006), but policies to further financial integration are being applied. There is a similar debate regarding further domestic liberalisation (see chapter 1). These two (connected) debates are largely in the realm of economics, and seek to understand the relationship between various forms of liberalisation and growth. Even if a positive causal relationship between liberalisation and growth is accepted, there remains the reconciliation of ‘the market logic of efficiency and the political logic of authority’ (Andrews *et al.* 2002: 3), or, more prosaically, of short-term politics and long-term economic performance (Geddes 1994). This study demonstrates clearly that government policy autonomy will be undermined by increased financialisation.

What Should Governments Do About Financialisation?

In part, financialisation is the result of government policy choice. Therefore, this study ends with the normative issue of whether governments should help or hinder the process of financialisation. Possible plausible explanations for the choices governments have made in favour of liberalisation include: the ideational (Gill and Law 1989; Helleiner 1994); Sobel’s (1994) ‘inside-out’ analysis of domestic interests; the structural explanation (Andrews 1994); and a ‘realist model’ (Cohen 1996: 275) which sees the influence of developed world state power on financial globalisation, including as directed through the international financial institutions. The central concern here, however, is with why governments have sought to increase the financialisation of government bond markets. The motivations can be short term. By removing the controls on foreign investor entry into the domestic market, the Brazilian authorities hoped that international demand would lead to a reduction of interest rates in an election year.²⁵

²⁵ Head of Research, fund management company, London, interviewed 14 February 2006.

From a more long-term perspective, discussions above regarding both Brazil and Turkey show how international investors can be used to develop a market through their willingness to purchase longer maturity government bonds. In addition, Borensztein *et al.* 2006 find a positive correlation between the removal of controls on capital inflows and the size of the government bond market. There is a trade off for any government, however, because the development of the market comes at the price of decreased policy autonomy. For a government, decreased autonomy can be justified as a temporary measure. To repeat an earlier quotation:

[W]here you want to get to...is 30-year bonds, issued in local currency at reasonable interest rates, owned by your own investors...And once you've got there, you can be an Italy or Japan and have huge debt to GDP, and it's financeable and nobody really cares...because you're...immune to external prices. But, in order to get there in the short term, you have to take on more vulnerability to external events. Because it takes time to build that yield curve, out in the global investor base.²⁶

A government, following this line of reasoning, must first move to the right along the autonomy curve, losing autonomy, in order to then move back to the left as the proportion of domestic investors in the government debt market increases once more. This study demonstrates, additionally, that the emphasis should be on loyal investors, both international and domestic.

The high point of the autonomy curve is represented by a market dominated by investors with a high degree of loyalty to government debt and the ability to buy long maturity government bonds, primarily pension funds. This point can be reached in a country where pension funds are relatively highly financialised. Chile, where 85 per cent of the government debt market is owned by domestic pension funds (Borensztein *et al.* 2007: 155), is probably the emerging market country which comes closest to this point.²⁷ How can countries get from their current position to there? While the observations here have

²⁶ Head of Research, fund management company, London, interviewed 14 February 2006.

²⁷ Helped by the government bond market growing at less than the growth of GDP (Borensztein *et al.* 2006: 4).

implications for economic policy, questions of government policy autonomy are the focus. Three points are worth emphasising. The first point is that the appropriate policies will vary greatly for each country, just as their levels of indebtedness do. Loyal investors can be developed, but not quickly. Lebanon's exceptionally high ratio of loyal investors is the result of developments over many years, some of which are largely independent of government policy. More fundamentally, the size of an economy will have a strong influence on international investor interest (Borensztein *et al.* 2006). The second regards the staging of liberalisation. Chilean government policy only reduced loyalty enforced by regulation as the capacity of the pension funds was high enough relative to the government's financing needs (see chapter 4). The cautious approach of the Lebanese authorities to the Lebanese banks establishing operations abroad can be seen in the same light (see chapter 2). Whilst policy reversal is possible, moving to the left along the autonomy curve is likely to be very much more difficult than moving to the right (Goodman and Pauly [1993] reach a similar conclusion regarding capital controls). This point on the timing of liberalisation also mirrors the debate regarding capital controls, and the IMF attitude towards them (e.g. Eichengreen 1999; Noble and Ravenhill 2000; Stiglitz 2002b).

The third point, and the one that ends this thesis, goes to the heart of the potential change in the relationship between states and markets, and the one which the use of financialisation as the independent variable in this analysis does the most to reveal. Should governments encourage or resist ever-greater financialisation? I have deliberately avoided in this thesis the use of the word 'speculative' to describe any of the financial market activities, in an attempt to avoid the 'dangers in stiff-necked moralism about speculation' (Dore 2000:9). The distinction between 'speculative' and 'productive' financial capital is so politically loaded as to be near useless. However, the abandonment of any distinction between speculative and productive capital is part of a more general move to liberalisation. Speculation (including shorting) is considered to be, by definition, productive, because it 'can be seen as contributing to the 'completeness' of markets' (Crockett 2007: 22). However, there is a strong argument for revisiting this

distinction and considering whether an uncontrolled financialisation is indeed ‘productive’, and therefore whether governments should employ policies, such as limiting the development of a ‘repo’ market or the activities of hedge funds, which limit outright short selling.²⁸ This is hardly a radical suggestion. The U.S. Securities and Exchange Commission employs restrictions on short selling (only possible if the last price movement was upwards) and the New York Stock Exchange has circuit breakers if prices fall too far.²⁹ ‘Policies that work for developed countries may not transfer well into emerging market territory’ (Calvo 2005: 509), but it is unlikely that this should be seen as an argument for greater financialisation in emerging markets than in developed countries. The eventual presence of all different types of investors in a government bond market is not inevitable (Froud *et al.* 2000: 106), and this study would suggest that the focus of government policy should be on developing loyal investors, not facilitating the disloyal.

Eichengreen and Mathieson’s study of hedge funds is most often quoted for its conclusion that hedge funds did not cause the Asian crisis (e.g., Ubide 2006).³⁰ Their conclusion (1998a: 1), however, is:

[T]here is some concern that hedge funds can dominate or manipulate particular markets. Limited measures to strengthen supervision, regulation, and market transparency might be considered to deal with this concern. These include replicating in other markets the large-trade and position reporting mechanisms in place in countries like the United States as a way of rendering hedge fund operations more transparent, raising margin and collateral requirements, and

²⁸ This need not be at the expense of the ability genuinely to hedge risk. It could, indeed, serve to limit the activity ‘of hedge traders who make their money as often as not by destroying the hedges that prudent traders build, rather than tending and mending them’ (Dore 2000: 9).

²⁹ This suggestion could be seen as an addition, or alternative, to the range of ‘trip wires and speed bumps’ in the way of financial globalisation proposed by self-styled ‘heterodox economists’ (e.g., Grabel 2003a and b).

³⁰ Eichengreen and Mathieson’s conclusion is based on the small size of hedge funds relative to other institutional investors. They quote a number of estimates of hedge fund assets at the time of the Asian crisis, ranging from US\$90 – 368 billion. By March 2006, assets exceeded US\$1,500 billion (Schurr 2006).

restricting the ability of financial institutions to lend domestic assets to nonresidents.

However tentative, this is a recommendation to limit financialisation. In contrast, '[i]ts more sanguine proponents typically extol a necessary surrender of sovereignty to the rational economic logic of markets' (Pauly 1995: 373). Issues of crises bought about solely by changing market expectations (Calvo 1996), taken with the cost of financial crises, at least question such sanguinity. This study adds the conclusion that the focus of these concerns should not be solely with the activities of international investors.

Financialisation is by no means complete anywhere, and it may be that the increase in pension fund assets globally may slow or reverse the movement along the autonomy curve, as noted by some interviewees in the markets studied here. Short selling constraints have also been noted. There are many other reasons to see complete financialisation (if that can even be defined) as impossible and movement to the left along the autonomy curve as possible. Nevertheless, the developments highlighted in this thesis are very much in the direction of increased financialisation and therefore reduced government policy autonomy, as a result of developments that are both very recent and little studied. One of the central messages of this study is that many of the developments that are contributing to the potential loss of government policy autonomy are occurring largely under the academic, and particularly the IPE, radar. It is financialisation, with all its different facets, that should be the focus of enquiry.

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Appendix A

Constituents of the JP Morgan Emerging Market Bond Index Global (EMBI Global). As of 27 February 2004

Country	Index Weighting (Per Cent)	External Debt (% of GNI) 2005
Argentina	1.63	64.6
Brazil	19.01	24.4
Bulgaria	1.48	62.3
Chile	1.68	43.1
China	1.33	12.5
Colombia	4.43	32.2
Cote d'Ivoire	0.06	68.7
Croatia	0.20	80.9
Dominican Republic	0.31	26.7
Ecuador	1.31	49.6
Egypt	0.69	38.3
El Salvador	0.83	43.2
Hungary	0.33	64.5
Lebanon	1.12	104.4
Malaysia	3.81	41.1
Mexico	18.03	22.1
Morocco	0.44	32.8
Nigeria	1.26	25.6
Panama	1.82	68.1
Peru	2.16	38.6
The Philippines	4.06	57.3
Poland	1.28	33.8
Russia	14.65	30.7
South Africa	1.42	13.1
South Korea	4.87	N/A
Thailand	0.27	30.3
Tunisia	0.30	65.5
Turkey	6.22	47.3
Ukraine	0.84	40.7
Uruguay	0.80	89.8
Venezuela	4.37	32.0

Source: JP Morgan (2004), World Bank

Appendix B

Table 1

**The Consolidated Assets of Commercial Banks Operating in Lebanon,
end April 2006**

	Billion LBP	Percentage Of Total Assets
Reserves	29961	27.12
- Of which Cash	233	0.21
- Of which Deposits at the Central Bank	29728	26.94
Claims on the Private Sector	25303	22.90
- Of which Claims denominated in Lebanese Pounds	4509	4.08
- Of which Claims denominated in Foreign Currencies	20794	18.82
Claims on the Public Sector	29976	27.13
- Of which Treasury Bills in Lebanese Pounds	14520	13.14
- Of which Treasury Bills in Foreign Currencies ¹	15367	13.91
Foreign Assets	21230	19.22
- Of which Claims on Non-Residents	1848	1.67
- Of which Claims on Non-Resident Banks	15919	14.41
- Of which Other Foreign Assets	3462	3.13
Fixed Assets	3505	3.17
Unclassified Assets	509	0.46
TOTAL ASSETS	110484	

Source: Banque du Liban²

¹ Holdings of international bonds issued by the Lebanese Republic.

² Quoted by Association of Banks in Lebanon Economic Letter May 2006.

www.abl.org.lb/ABL/Pictures/Appendix%20May%202006.pdf, accessed 3 July 2006.

Outstanding debt classified as 'Market Eurobonds' totalled LP19,901 billion³ (US\$13.2 billion), meaning the Lebanese banks owned 77.2% of outstanding Eurobonds.

³ *Public Debt Monitor*, Ministry of Finance, April 2006, p.11. Available at www.finance.gov.lb, accessed 31 January 2007.

Table 2**Balance Sheet of the Turkish Banking Sector, end December 2005**

	US\$ Million	Percentage Of Total Assets
Cash	2156	1.10
Due from the central bank	8982	4.59
Due from money markets	4431	2.27
Due from banks	19242	9.84
Securities – Trading Portfolio (net)	12910	6.60
Securities – Available for Sale (net)	58032	29.67
Required Reserves	10827	5.54
Reserve Repo Receivables	3188	1.63
Loans	11643	5.95
Past Due Loans (net)	569	0.29
Income & Income Accruals	8088	4.14
Lease Financing Receivables (net)	225	0.12
Subsidiaries, Associated and Joint Controlled Companies (net)	8198	4.19
Securities – Held to Maturity (net)	35548	18.18
Fixed Assets to be Sold (net)	1324	0.68
Fixed Assets (net)	5557	2.84
Other Assets	4663	2.38
Total Assets	195582	

Source: Banking Regulation and Supervisory Agency (BRSA) 2006

The exposure to the government is not directly identified in these figures, but is contained in the securities portfolios, which, across the three accounting categories, total US\$106,490 million, or 53.45 percent of total assets. As of November 2003 (the most recent available data), 96.3 percent of the securities portfolio was government securities (BRSA 2004: 7), so a figure of approximately 51 percent appears a reasonable assumption for total exposure to the government bond market.⁴

Table 3

Assets of Brazilian Deposit Money Banks⁵, end October 2006

	R\$ Million	Per cent
Reserves	208,318	14.07
Other claims on monetary authority	1,686	0.11
Foreign assets	56,132	3.79
Claims on central government (includes securities debt)	406,647	27.46
Claims on state and local government (includes securities debt)	3,011	0.2
Claims on nonfinancial public enterprises	4,752	0.32
Claims on private sector	782,532	52.84
Claims on other banking institutions	17,779	1.20
Claims on nonbanking financial institutions	49	0
Total Assets	1,480,906	

Source: Banco Central do Brasil⁶

⁴ Deputy General Manager, Turkish bank, interviewed 5 December 2005, noted the absence of alternative securities to purchase, such as corporate bonds.

⁵ Comprises commercial banks, multiple banks, Banco do Brasil SA and Caixa Econômica Federal. The last two are state-owned banks.

⁶ www.bcb.gov.br/?BULLETCR, Excel file B2-0612I.xls, Tab2-13i, accessed 26 January 2007.

Table 4

**Ownership of Turkish government bonds by non-bank investors,
27 October 2006**

	Thousand TRY
Non bank Residents ⁷	68,084,254
Securities Mutual Funds (Resident)	10,092,560
Nonresidents ⁸	32,413,103
TOTAL	110,589,917

Source: Turkish Treasury⁹

These figures are based on market values, and so, in a period of generally falling interest rates and resultant rising market prices, will overstate the total figure relative to outstanding debt amounts, but the inclusion of foreign branches of Turkish banks may mean the figure also understates the Turkish bank holdings. Nevertheless, it provides a comparison with the total outstanding volume of domestic government debt as of the end of October 2006.¹⁰ This was YTL250,946 million, of which YTL74,548 million was held by the public sector (including the central bank, non-cash sales to public banks and the savings deposit insurance fund), and YTL176,398 million is termed by the Treasury as ‘market’. So, according to these figures, of the outstanding domestic ‘market’ debt of the Turkish government, 62.7 percent is owned outside the banking sector, 37.3 percent by banks.

⁷ Excludes the Savings Deposit Insurance Fund and Compulsory Saving Account.

⁸ This figure includes the foreign branches of Turkish banks.

⁹ www.hazine.gov.tr/english/kaf/2006dibs_eng.xls, accessed 4 January 2007

¹⁰ www.hazine.gov.tr/english/kaf/2006stocklender.htm, accessed 7 January 2007.

Table 5

Ownership of Lebanese Domestic Government Securities, end October 2006

	LBP Billion	Percentage
Central Bank	9063	29.84
Banks	16923	55.71
Non Banking System	4389	14.45
Total	30375	

Source: Banque du Liban¹¹

Table 6

Ownership of Brazilian Domestic Government Securities, end September 2006

	Real million	Percentage
Banks' Proprietary Holdings	327,405	32.26
Banks' Bound Securities ¹²	110,716	10.91
Individuals	1,654	0.16
Non-financial Corporates and Others	68,108	6.71
Mutual Funds	506,894	49.95
Total	1,014,778	

Source: Brazilian Treasury¹³

¹¹ www.bdl.gov.lb/edata/ListAllSeries.asp, accessed 7 January 2007.

¹² 'Securities bound to reserve requirements on savings accounts and time deposits, capital increase, pension funds provisions, external funds, liquidity loans, collateral deposits in clearinghouses, collateral and escrow accounts'.

¹³ www.tesouro.fazenda.gov.br/english/hp/public_debt_report.asp, Table 7, accessed 7 January 2007.

Table 7

**Accounting Treatment of Brazilian Bank¹⁴ Securities and Derivatives Holdings,
end June 2005**

	Trading Book	Available for Sale	Held to Maturity
Government owned	28.4	27.9	43.7
Domestic private	60.2	29.1	10.7
Foreign	36.8	53.7	9.5

Source: Banco Central do Brasil

Table 8

Accounting Treatment of Turkish Bank Securities Holdings, end December 2005

	Trading Book	Available for Sale	Held to Maturity
Government owned	5.5	39.9	54.5
Domestic private	13.7	69.7	16.5
Foreign	61.7	28.7	9.6

Source: Banking Regulation and Supervision Agency
2006

¹⁴ 'Consolidated Banking Segment I' which held 94 percent of the National Financial System holdings of securities and derivatives.

Table 9

Basel II Credit Risk Weighting

Credit Assessment	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-	Unrated
Risk Weight	0%	20%	50%	100%	150%	100%

Source: Basel Committee on Banking Supervision 2005: 15¹⁵

¹⁵ The document uses Standard & Poor's rating notations for long term ratings. However, this does not 'express any preferences or determination on external assessment institutions by the Committee' (Basel Committee on Banking Supervision 2005: 15). Both Standard & Poor's and Moody's ratings are used in the report for short-term ratings (*ibid.*: 26).

Appendix C

List of Interviewees

Set out below are the names of the employers of interviewees. One person from the institution was interviewed unless stated.

London, 4 January 2005 – 16 February 2006

ABN Amro Bank (2 interviewees)
Ashmore Investment Management (2 interviewees)
Credit Suisse First Boston
Deutsche Bank Asset Management
Dewey Ballantyne
Foreign and Colonial Asset Management
Fiduciary Trust
Hong Kong and Shanghai Banking Corporation
Julius Bär Asset Management
Lehman Brothers (2 interviewees)
Merrill Lynch
Morgan Stanley (7 interviewees)
Pictet Asset Management
Union Bank of Switzerland (2 interviewees)
Whitebeam Capital Management (3 interviewees)

Not identified at interviewee's request:

U.S. Insurance Company

New York, 15 – 31 May 2006

Alliance Bernstein
Emerging Sovereign Group (2 interviewees)
Lehman Brothers (2 interviewees)
Morgan Stanley (5 interviewees)
Trident Investment Management

Beirut, 2 – 12 September 2005

American University of Beirut
Association of Banks in Lebanon
Bank Audi (5 interviewees)
Bank of Beirut and the Arab Countries
Banking Control Commission
Bank de la Méditerranée
Banque du Liban (2 interviewees)
BLOM Bank
BNP Paribas
Byblos Bank
Credit Libanais (2 interviewees)
Fransa Bank
Intercontinental Bank of Lebanon
Lebanon Gulf Bank
Ministry of Finance (3 interviewees)
Ministry of Finance (former official)
Near East Commercial Bank
Societe Generale de Banque au Liban (2 interviewees)

Ankara, 30 November – 2 December 2005

Banking Regulation and Supervisory Agency
Central Bank of Turkey (2 interviewees)
Economic Policy Research Institute
Turkish Treasury (4 interviewees)
Turkish Treasury (2 former officials)

Istanbul, 5 – 11 December 2005

Akbank (2 interviewees)
Economic Policy Research Institute
EFG Istanbul Securities
Finansbank (2 interviewees)
Fortis Bank (2 interviewees)
Garanti Bank
Industrial Development Bank of Turkey (2 interviewees)
Is Invest (3 interviewees)
Istanbul Stock Exchange
JP Morgan (2 interviewees)
Koç Bank
Oyak Bank (2 interviewees)

Istanbul (ctd.)

Türkiye İş Bankası
Ziraat Bank (2 interviewees)

Name not revealed at interviewee's request:

European bank

São Paulo, 29 August – 4 September 2006

A.C. Pastore and Associados
ABN Amro Real
Brazilian Mercantile and Futures Exchange (3 interviewees)
Deutsche Bank (2 interviewees)
Febreban
HSBC Bank Brasil
Banco Itaú
Banco Itaú BBA
Mauá Investimentos
UBS Wealth Management
Unibanco
Unibanco Asset Management

Brasilia, 5 – 6 September 2006

Banco Central do Brasil (4 interviewees)
Ministry of Finance (2 interviewees)

Rio de Janeiro, 11 – 12 September 2006

Banco Central do Brasil (former official)
Gávea Investimentos
JGP
Nobel Asset Management
Pontificia Universidade Católica de Rio de Janeiro